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Dear Andy

RE: Avonmouth Liquified Natural Gas facility C3 price review: Interim Proposals

Thank you for the ongoing Avonmouth LNG facility C3 price review. This letter is National Grid Gas LNG storage (LNGS) response to Ofgem's initial proposals consultation.

Constructed in the 1970's to more economically support peak winter gas demands than pipeline, Avonmouth is the only remaining gas liquefaction and storage facility in the UK. In absence of very significant capital reinvestment, the plant is coming to the end of its useful economic life with increasing risks of failure of critical assets.

Pending new Transmission assets being commissioned around 2018, the site continues to provide 1 in 20 demand support for gas consumers located in the South West of England. It also holds stocks that form part of the NTS System Operators' emergency arrangements[1]. Following closure of the Glenmavis LNGS facility in Scotland, Scotia Gas Networks (SGN) also utilise the facility to fill road tankers supplying LNG to its remote Scottish Statutory Independent Undertakings[2].

Subsequent to the regulated services being quantified and booked by gas transporters, and subject to there being any remaining liquefaction, tank storage or vaporisation capability, LNGS then offer storage services to gas shippers or road tanker operators under unregulated tariffs. Given the high capital outlay and operating costs of a liquefaction and storage plant these latter services sell at an overall loss relative to the true costs of providing the service. However any revenues above the marginal variable costs of operation contribute toward costs that would otherwise be recovered from consumers of regulated services.

As stated in Ofgem's consultation, the principle of the regulated C3 price cap mechanism is that forecast revenues should equal forecast costs for the period under consideration. This ensures that gas consumers supplied by regulated transporters pay proportionately for the benefits they receive and avoids any cross subsidy between other LNG markets. To achieve this Ofgem compare the expected costs and revenues for services to both regulated and unregulated customers, and then adjust the scale of charges (or C3 prices) for regulated services. To avoid direct losses and deliver any short term profit, a very strong incentive is created to maximise unregulated revenues, and minimise total costs.

[1] Under GSM(R) regulation Gas Transporters are required to prepare and have approved by the HSE a safety case. LNG stored at Avonmouth forms part of NGGs' arrangements to minimise the risk of a supply emergency by maintaining adequate NTS pressures in the event of prescribed scenarios.
[2] SGN owns and operates distributed gas networks supplying around 7500 customers in Campbeltown, Oban, Wick, Thurso from re-gasified LNG.

The price cap mechanism only works where forward looking volume forecasts turn out to be correct and to inform Ofgem's data request underpinning their C3 price review, we engaged with our regulated and unregulated customers to understand their future requirements for LNG services and thereby determine the capital and operating costs necessary to fulfil these.

We are therefore pleased that Ofgem's initial proposals largely accept[3] our forecast level of costs and have aligned depreciation to the remaining economic life of the site. As stakeholder engagement is a key principle of RIIO it is disappointing that Ofgem have chosen to disregard the results of a process of engagement which it promotes as best practice in favour of their own analysis which appears to lack a rigorous basis. As a result there is a disproportionate split in recovering costs relative to the benefits received by different customer groups. Ofgem also ignores the risk that significant withdrawals of stock in any given year, for example of Operating Margins, would limit LNGS' ability to offer anything other than regulated services the following year due to the limited liquefaction capability. These factors could lead to a significant shortfall in costs funded by regulated consumers and a direct loss in operating the site.

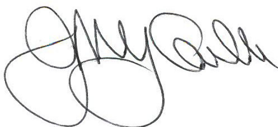
Given our programme of customer engagement we believe LNGS forecasts of demand for future services, aligned with our forecasts of costs supported by Ofgem, are a prudent and fair reflection of the most likely case going forward.

LNGS view is that decommissioning costs should be treated consistently with other regulated assets across the energy business. It believes that the proposed treatment of LNG Storage facilities may be inconsistent with that of, for example, low pressure gas holders. Gas consumers have received significant financial benefits from the economic and efficient development and operation of LNGS plants throughout their lifecycle. As the topography of the NTS and its supplies has evolved, NTS pipeline assets are now more economic and these have been accepted by Ofgem for substitution during RIIO-T1. Given consumers have received the benefits of the LNGS plant, it is appropriate they, rather than NG shareholders fund the decommissioning costs. In its Initial Proposals Ofgem suggest NG shareholders have benefited from the revenues of commercial services, and the transfer of Isle of Grain site from the unregulated business. It is however clear that the benefits of operating the Avonmouth site are extremely limited given Ofgem's methodology for determining C3 prices is to limit revenues to total costs incurred excluding any provision for future decommissioning. Furthermore the GB market, which has traditionally relied on the North Sea as a just in time supply system, has consistently valued storage below the true costs of provision, hence the absence of significant investment in gas storage following the move toward importation dependency. Similarly the transfer of the Isle of Grain assets to the unregulated importation terminal have avoided consumers funding the costs of continued operation as a peak shave facility as well as decommissioning that they would otherwise have occurred. LNGS therefore believe that an allowance under C3 for decommissioning costs is fully justified.

The remaining part of this letter seeks to respond directly to the areas on which Ofgem's are consulting under its Initial Proposals.

To avoid the prospect of having to consider the withdrawal of services as a means of countering the cash losses implied under the initial proposals, LNGS welcomes further work with Ofgem to develop a more targeted incentive mechanism around revenues which through the application of caps and collars would ensure a fair allocation of risk and reward between consumers and shareholders.

Yours sincerely



Jon Carlton
Director UK LNG and Metering
cc Chris Train, Director Network Operations - NGG

[3] Ofgem's Initial Proposals allow 94% of LNGS capex submission excluding only the costs of security fence upgrades which they don't consider critical to the actual operation of the facility.

Question 1. *Do you agree with our Initial Proposals that NGG and SGN should be more exposed to the capex costs and return on asset base associated with the provision of regulated services at Avonmouth?*
LNGS strongly support Ofgem's stated methodology for setting C3 prices such that consumers protected by price regulation bear an efficient level of costs commensurate with those incurred providing the service. As outlined earlier, LNGS believe that with the exception of variable liquefaction costs which are recovered directly through pay as you go commodity charges, the vast majority of future capital and operating costs are necessary in the provision of core regulated services. However Ofgem's initial proposal allow a 44% recovery and return on capex costs based on its projection of volume splits between regulated and unregulated services. In the event that outturn splits differ, which LNGS believes is a highly probable outcome given prevailing market information, this will lead to a significant underfunding from regulated customers and place additional significant financial risks on the LNGS business.

Ofgem accept NGG's ongoing requirement for Operating Margins and Constrained LNG until new NTS pipelines are commissioned in 2018. It is however forecasting that full volumes and revenues will be received from SGN until 2018. This is contrary to the position stated by SGN in their open letter response where they view 2018 as a backstop resulting from NGG's substitution. LNGS believe the single point failure risk of the annual liquefaction process and road tanker loading facility creates a strong incentive for SGN to remove its reliance on Avonmouth and implement an enduring alternative at the earliest opportunity. LNGS also believe that the current cross subsidy from GB consumers to the SIU's, estimated by Ofgem at £2,200 for each SIU household for the year 12/13[4], creates a strong financial incentive for a more efficient and economic enduring long-term solution. We believe it is these factors driving SGN's reluctance to give us any assurance around future requirements beyond 2015/16.

As our revenue assumptions were provided directly from SGN, and ignore phased substitution occurring within the next 3 years giving rise to a risk to LNGS, we believe they represent a fair balance.

As LNGS have no control or influence over the timing of SGN's substitution, in setting volume assumptions that determine fixed C3 prices, Ofgem should ensure that the timescales and phasing for SGN's exit are accurate, and, or allow for ex post correction of any material changes to those forecast.

As indicated by actual revenues over the last decade, the only potentially profitable unregulated market remaining for gas liquefaction and storage facilities is primarily from tanker operators and fuel distributers. Whilst LNGS recognise there may be a growing market for LNG as a more environmentally and economically efficient fuel for HGV and off-grid customers currently burning fuel oil derivatives, imported LNG is potentially capable of meeting this demand at a significantly lower cost and environmental footprint. The use of LNG 'at source' also removes the single point failure risks of Avonmouth's aging assets and mitigates the uncertainties of an annual service being available because of the limited liquefaction and priority rights of regulated customers . Consequently we believe that reductions in income are inevitable as more UK and North West European terminals introduce LNG tanker loading facilities in direct competition to Avonmouth. LNGS believe that

[4] http://www.ofgem.gov.uk/Networks/GasDistr/RIIO-GD1/ConRes/Documents1/3_RIIOGD1_FP_Finance_and_uncertainty.pdf

developments in these markets are not reflected in Ofgem's initial proposals as they assume LNGS will continue to receive the current level of volume bookings and revenues through to 2018.

Question 3: *Do you think it is appropriate to include commercial revenues forgone in the consideration of the C3 price cap.*
LNGS do not believe it is appropriate for Ofgem to take into account revenue forgone when calculating the C3 price particularly when it is asserted that NG shareholders will benefit from any increased revenues at its unregulated Isle of Grain LNG importation facility. This facility operates in a competitive market with many other importation terminals as well as alternative technologies and competing fuels.
Consequently, should Grain LNG decide to proceed it will have to take the significant investment risk where profits are uncertain. As such any revenues and risks should be considered entirely separate from the regulated LNGS businesses. Irrespective of investment by NG shareholders in its unregulated importation business, Avonmouth revenues would ultimately decline as other terminals provided services at lower cost and risk than through re-liquefaction and storage.

Question 2: *Do you agree with our Initial Proposals to remunerate the regulated share of Avonmouth based on the economic life of the asset rather than its design life.*
As the last remaining liquefied gas and storage facility in the UK and in absence of a demand for services at a price supporting critical capital reinvestment, Avonmouth remains scheduled for closure at the earliest opportunity. We therefore believe full remuneration and allowances for depreciation within the forecast economic life is justified.