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Direct Dial: 0207 901 1873  
Email: Philippa.Pickford@ofgem.gov.uk  
Date: 25 February 2014

Dear Colleague,

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

Special Condition 8C.2 of the National Grid Gas plc (NGG)'s Gas Transporter Licence in respect of its National Transmission System (NTS) (the NTS Licence) requires NGG to use reasonable endeavours to procure its Operating Margins (OM) requirements in an economic and efficient manner and promote competition in the provision of OM, for each year from 1 April 2013 to 31 March 2021.

Special condition 11E establishes the charges that the licensee may charge for the provision of Operating Margins from National Grid (NG) Liquefied Natural Gas (LNG) storage facilities. The Authority can suspend the current regulated prices for the provision of OM services from NG LNG storage facilities, as specified in Special Condition 11E of the NTS Licence. It was intended that if there was sufficient competition, 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 regulated prices for the provision of OM services as specified in Special Condition 11E of the NTS Licence (referred to in this letter as the "11E prices")<sup>2</sup>.

During the course of its consultations on its SO incentive scheme for 2010/11, NGG raised concerns that the market for OM provision was not homogenous<sup>3</sup>. As a result of these concerns, a modification to Special Condition C3<sup>4</sup> 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>5</sup>.

Based on the criterion set out in a letter to the industry in December 2009<sup>6</sup>, we directed the suspension of the application of the C3 prices for Locational North, Orderly Rundown and

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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> In January 2013 Ofgem directed the modification of Special Condition 11E setting out the new regulated prices from 1 May 2013.

<https://epr.ofgem.gov.uk/Content/Documents/National%20Grid%20Gas%20Plc%20-%20Special%20Conditions%20Consolidated%20-%20Current%20Version.pdf>

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

<sup>4</sup> Special condition C3 was the former domain of the Operating Margins regulated prices. Under the current licence, SC 11E is the condition that covers these prices.

<sup>5</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>6</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)

Non-locational services in February 2010 with effect from 06:00 1 May 2010 to 06:00 1 May 2011<sup>7</sup>.

It is also worth noting that the provision of OM services 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 [Health and Safety Executive] (HSE) in February 2010. Therefore the provision of OM services to NGG NTS is open to a full range of facilities.

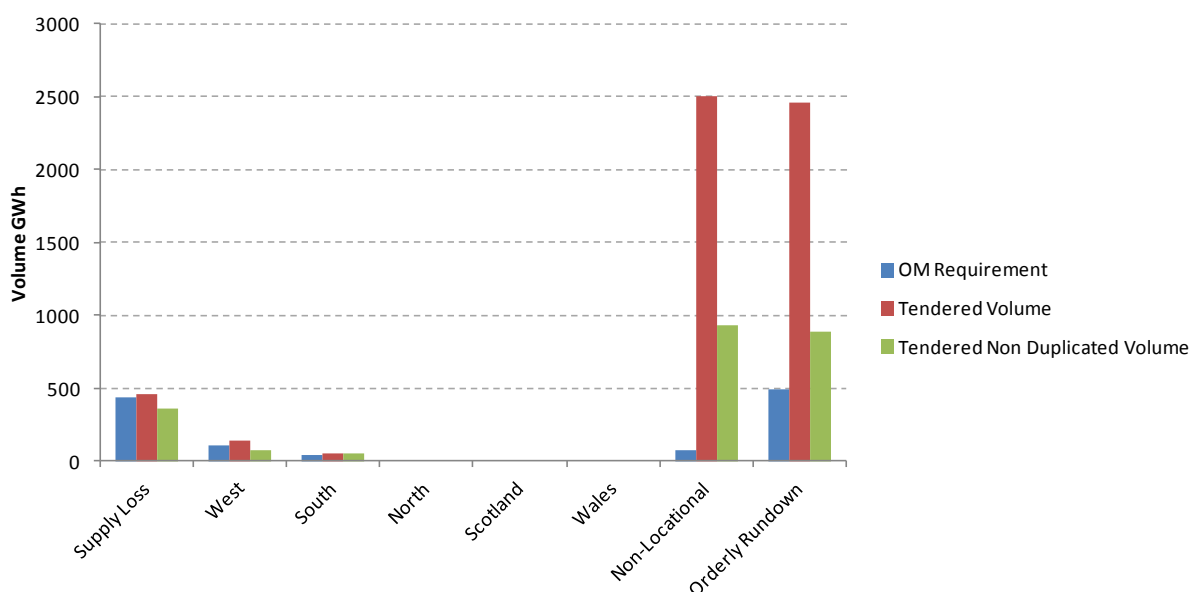
In November 2010 we issued a letter to the industry<sup>8</sup> setting out that we were minded to suspend the C3 prices for the relevant period of OM provision provided that we judged the tender process to have been effective for the OM requirement type and setting out the criterion on which we would 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 2012<sup>9</sup>. We issued similar letters in February 2012<sup>10</sup> and February 2013<sup>11</sup>.

### Assessment of OM Tender for 2014/15

We have assessed the effectiveness of the competition resulting from the OM tender process for 2014/15. 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 2014/15. Source: NGG



<sup>7</sup> 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)

<sup>8</sup>

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

<sup>9</sup> See our decision letter of 24 February 2011

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

<sup>10</sup> <https://www.ofgem.gov.uk/ofgem-publications/53371/om-decision.pdf>

<sup>11</sup> <https://www.ofgem.gov.uk/ofgem-publications/53356/om-decision-2013.pdf>

The blue bar in Figure 1 represents the volume requirement of each OM service and the red bar represents the volume of offers received in the tender from non-NG LNG providers. 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, Non-Locational and Locational South requirements can be met without any requirement for services from NG LNG storage facilities. We have analysed the results of these tenders, including undertaking "pivotality tests"<sup>12</sup>. Having considered this analysis we are satisfied that competition is effective for the provision of Non-Locational OM requirements. On the basis of pivotality tests we do not consider that competition is effective for Orderly Rundown or Locational South.

For the reasons set out above, the Authority intends to direct the suspension of the application of 11E prices for the following services<sup>13</sup>:

- Non-locational.

The suspension of the application of these 11E prices will take effect from the start of the Gas Day<sup>14</sup> on 1 May 2014 to the start of the Gas Day 1 May 2015 i.e. the duration of the 2014/15 gas storage year associated with the 2014/15 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, Orderly Rundown 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 Leonardo Costa (0203 263 2764) in the first instance.

Yours sincerely

Philippa Pickford  
Associate Partner, Wholesale Market Performance

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<sup>12</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>13</sup> For further details see the attached direction.

<sup>14</sup> Gas day as defined under the Uniform Network Code (UNC)