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Dear Ian

Re: Conclusions on Operating Margins Contestability and Initial Thoughts for Associated SO Incentive Arrangements

Thank you for the opportunity to respond to the “Conclusions on Operating Margins Contestability and Initial Thoughts for Associated SO Incentive Arrangements” document published on 2nd September 2008.

The development of competition in Operating Margins (OM) services is an essential step toward ensuring that National Grid LNG storage (NG LNGS) is able to operate on a fully commercial basis and thereby establish a profitable and sustainable business model. To this end, we continue to support the process being undertaken by National Grid Gas (NGG) and look forward to participating in the competitive tender process to be held during winter 2008/09.

The charges that NG LNGS currently levies for OM services are restricted by tariff caps set by Ofgem. In order to ensure that such regulated charges do not prejudice the outcome of the proposed tender, we believe that it is important that NG LNGS be permitted to bid a set of prices into the tender process that enables it to cover the full costs (and risks) associated with providing OM services in a fully competitive market. Amongst other things, in order to underpin the provision of OM services over the medium to longer term, the bid prices would need to take account of greater levels of capital expenditure than assumed by Ofgem when setting the current tariff caps. We have highlighted this as an issue to Ofgem and look forward to working with them over the coming months to develop a suitable way forward.

In the event that the winter 2008/09 tender process (or subsequent tender processes) demonstrates the existence of competition in OM services, we believe that it would be appropriate to remove the rights of pre-emption which NGG currently holds over capacity in the LNG storage facilities. In our opinion, the continuation of such rights would unfairly restrict NG LNGS’s commercial freedom and potentially undermine any future OM tender processes. We would therefore propose to engage with all relevant stakeholders, including

Ofgem, the Health and Safety Executive and NGG, in order to seek the required changes to the Uniform Network Code (possibly on a site-by-site basis) as soon as it becomes clear that NGG is no longer dependant on securing access to capacity in the LNG storage facilities in order to meet its OM requirements.

Within the remainder of our response, we have largely limited our comments to the contracting principles and procurement strategy to be adopted by NGG in purchasing OM services. We believe that other parties will be better placed to respond to the specific issues related to the provision of OM services by other (i.e. non-storage) potential service providers.

In order to realise a truly market based price for the provision of OM services, it will be important for NGG to maximise the level of participation in the winter 2008/09 tender process. In this regard, it will be essential to ensure that the barriers to OM provision by potential service providers, e.g. the implementation of any relevant UNC and/or Safety Case changes, are removed in advance of the tender process. It will also be important to ensure that each participant in the tender process is able to offer a service that aligns with their own physical and commercial capabilities i.e. there should be no standard contract for services. To this end, we support NGG's proposal to allow flexibility in terms of contract lengths and contract start dates and believe that it is important to allow participants complete freedom over whether to offer capacity only services (on either a "space only" or "fully bundled" basis) or "gas delivered" services.

Whilst flexibility in the tender rules will be important in order to encourage participation in the tender process, it will also be essential for NGG to be very clear on the minimum levels of service that it will require over the duration of the contract period. This information will be required in order to allow potential service providers to identify any necessary investment to meet NGG's requirements and to price the OM service accordingly. Such information could include minimum notice periods, minimum duration of OM usage, minimum period of time between successive usages of OM at a facility and minimum levels of service availability.

Another factor that will have a significant impact on bid prices is the liability arrangements that apply in the event of a failure to provide the contracted OM service. In our opinion, NGG's proposal to link liability payments to the SMP buy price would expose a service provider to unknown and potentially very high costs. This may discourage some potential service providers from offering an OM service and will almost certainly result in higher charges to NGG. To overcome this problem, we believe that liability payments should be set at a multiple of the service fee charged by a service provider and/or for a cap to be set on the overall level of liabilities faced by service providers.

With regard to the proposed use of zones to determine locational OM requirements, whilst we agree that it would be preferable to avoid an overly complex zonal division, it should be the case that the locational OM requirement within any zone is capable of being satisfied from any point within that zone. For example, with regard to the proposed west zone, it should be possible to meet any locational OM requirement from sources based in SW England or, alternatively, South Wales. To the extent that this is not the case, we believe that the proposed zones should be subject to further review.

Within the consultation document, NGG seeks views on what approach it should take to OM procurement if few or no additional OM service providers result from the efforts made to develop contestability. In our opinion, provided that there are no barriers preventing the entry of a new service provider into the OM market, the existing service providers should continue to be allowed to tender freely. If a party has simply failed to participate in the tender

because they felt they would not be competitive, this should not be allowed to invalidate the outcome of the tender.

In the event that the winter 2008/09 tender process is unsuccessful (or only partially successful) in establishing a competitive market for OM services, NG LNGS believes that NGG should be prepared to run a second tender process during Q2 2009 in order to allow potential service providers to review their position following publication of the winter 2008/09 tender results (which we believe should include certain pricing information such as average price of accepted bids and lowest price accepted bid). However, should it become clear that full contestability in OM services is not achievable due to the existence of barriers to entry that cannot be removed, then we believe that Ofgem should re-open the current LNG storage price control arrangements as early as reasonably practicable in order to ensure that NG LNGS can undertake the necessary investment to support the provision of OM services into the future.

With reference to the Next Steps, in our opinion it is essential that NGG allows a sufficient period of time prior to the tender to engage all potential service providers on the details of their service requirements and to enable contracts to be developed and understood by all parties. If this process is not undertaken with the correct level of dialogue, there is a significant risk that potential service providers will be uncomfortable with what they are being asked to provide and may therefore refrain from participating in the process or price their services incorrectly.

Finally, NG LNGS has a UNC obligation to publish its 2009 Annual Storage Invitation on the 1st March 2009. It is essential that we know prior to that date what level of OM service will be required by NGG at each of the LNG storage facilities in order that we can determine the amount of storage capacity that is to be made available to gas shippers via our annual auction process.

Yours sincerely

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