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Operating Margins: Contestability Update and Incentives

Dear John,

RWE npower welcomes the opportunity to respond to your recent consultation on the above and does so on behalf of all its licensed gas businesses and RWE Supply & Trading GmbH.

Our response to the questions raised in the consultation are as follows.

Question 3.1 - Are there any other activities that National Grid could reasonably do to promote a contestable market and to make a successful safety case demonstration?

We believe National Grid has responded well to the difficult challenge of promoting contestability in the provision of OM services and we are unaware of any other activities it could reasonably have taken. In the interests of transparency we hope that National Grid will provide potential OM market participants with further information about the outcome of the various aspects of testing undertaken with potential new providers (as described in Appendix 1), regardless of whether or not the safety case demonstration has been successful.

Question 3.2 - What additional information would be useful if provided within National Grid's Invitation to Tender (ITT) documentation or Tender Information Report?

It may be helpful to include summary information on capability (along the lines of that provided in Section 4), both by volume and number of sites, in future ITT documentation and Tender Information Reports. This will help to further highlight the extent to which contestability is possible, or has been achieved.

Question 4.1- Has National Grid sufficiently articulated the requirement and potential market for OM services?

Yes

Question 4.2 - Do you believe the new provider types, if approved through the HSE Demonstration case, could form a significant component of future providers of OM?

We believe that new provider types could form a significant component of OM

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provision. The extent to which they do will largely be influenced by National Grid's appetite for contracting for OM provision based on a floating exercise price, as new providers are unlikely to be able to value the loss of optionality arising from providing OM services based on a fixed exercise price.

Question 4.3 - Have you any comments in relation to the potential interaction between demand side provision of OM services and the electricity market?

CCGTs are only expected to offer OM provision to support network pressures in the event of a beach supply failure, forecast demand change or compressor/pipeline failure, not in support of "orderly rundown" in a Network Gas Supply Emergency. To this extent we would not expect provision of demand side OM services by CCGTs to cause any material constraints on the electricity network, or distortion in electricity market, as there is no reason to believe such gas market events will be coincident with constraints on the electricity network.

CCGTs which are able to offer OM services will need to take proper account of the consequences of being called to provide OM on their electricity imbalance positions and appropriately reflect these in their OM offers.

Question 5.1 – Does National Grid's proposed 2010 OM tender timescale affect, either positively or negatively, the ability for providers to participate?

The proposed 2010 OM tender timescale seems appropriate. We hope that the HSE will be able to make a decision on the necessary safety case change by the end of this year but in the event it has not been able to do so we think the 2010 invitation to tender should exclude new OM providers.

Question 5.2 - Is there any additional information which could be provided by prior to the tender which would help potential providers in clarifying their position on whether to participate?

We are not aware of any.

Question 6.1 - Is it appropriate to incentivise Operating Margins given the range of uncertainties? If so, what would be the most appropriate way (e.g. Cost minimisation) to incentivise Operating Margins?

Providing the HSE has made a decision on the necessary safety case change prior to the 2010 OM tender being issued we believe that OM services should be incentivised, regardless of whether the HSE approve or reject the safety case change. In the event it has not we believe that OM availability costs should continue to be treated as pass through costs, with procurement undertaken in accordance with National Grid's wider obligation to be economic and efficient.

Whilst it would be wrong to prejudge the conclusion of any market competitiveness test prior to the next OM tender taking place, information included in Section 4 serves to highlight National Grid LNG's continued dominance in OM service provision, even with a healthy level of participation from new OM providers. We would be surprised therefore if a convincing case could be made for the disapplication of regulated C3 prices based on this initial snapshot of capability.

Question 6.2 - Should the OM Incentive scheme continue to be separated into a 'Utilisation' and 'Availability' element?

In the event a successful safety case demonstration allows new providers to offer OM services we believe it may be most appropriate to develop an OM incentive scheme based on the combined utilisation and availability costs. This may represent the most equitable way of incentivising National Grid

to efficiently procure OM services from a number of different provider types and parties. Any combined cost target should be set within an appropriate cap and collar.

In the event the safety case demonstration is unsuccessful we believe it would be appropriate for the OM incentive scheme to be separated into utilisation and availability elements, in the same manner as applied in 2008.

Question 6.3 - Should National Grid be able to recover a return on the gas held in storage for OM purposes?

We do not understand what the implications might be on National Grid's price control revenue/formula of allowing it to recover a return on the gas held in storage for OM purposes. Nor do we understand how this might influence the contract assessment stack in line with its obligation to be economic and efficient. We would be grateful if National Grid could provide further information on these points to help our understanding.

Question 6.4 - What would be an appropriate length of an incentive?

We believe that 1 year is an appropriate length for an incentive bearing in mind that a competitive market for OM provision will continue to require nurturing and take further time to develop.

Yours sincerely,

Steve Rose*
Economic Regulation

* sent by e-mail therefore unsigned