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Dear John

Re: Operating Margins: Contestability Update and Incentives

Thank you for the opportunity to respond to the "Operating Margins: Contestability Update and Incentives" document published on the 14th September 2009.

The continued safe and reliable operation of the LNG storage facilities is a capital intensive activity which requires a stable (and sufficient) revenue stream to underpin long-term investments. The current LNG storage business model, based on short-term regulated and commercial services, is not sustainable in that it does not provide the required level of revenues to ensure the ongoing profitable operation of the National Grid LNG Storage business (NG LNGS) while making the necessary investments. To address this issue we are seeking to implement a revised business model based around the establishment of long term contracts for services with all of our customers, including National Grid Gas NTS (NGG NTS), Scotia Gas Networks (SGN) and gas shippers¹. To the extent this is not realised, and there is a continued reliance by NGG NTS and/or SGN for the provision of "regulated" services (i.e. contestability is not proven) from the LNG storage facilities, a revised regulatory treatment of the business will be required.

Consistent with this long-term contracting approach, NG LNGS continues to support the process being undertaken by NGG NTS to promote contestability in Operating Margins (OM) services and we look forward to the opportunity to participate in the 2010 OM tender process.

In order to realise a market based price for the provision of OM services, it will be important for NGG NTS to maximise the level of participation in its tender process and ensure that all potential service providers are able to participate on a level playing field. In this regard, we believe that it is essential that NGG NTS follows through on its intention to submit a Safety Case Demonstration to the Health and Safety Executive (HSE) regarding the provision of OM services from demand-side and supply-side service providers in a timescale that will allow the HSE to make a decision before the 2010 OM tender.

¹ On the 24th August 2009, NG LNGS published a Request for Proposals document in which we have invited expressions of interest in long term LNG storage services. The closing date for submission of non-binding proposals is the 16th October 2009.

A further factor which we believe has a bearing on the opportunity for potential service providers to participate in the tender process is the length of contract tendered by NGG NTS. In the 2009 tender process, NGG NTS only sought to let contracts for a maximum term of 3 years. We consider that this is an insufficient period of time to allow parties who may need to invest to provide OM services to undertake such investment and therefore discourages their participation in the tender process. We believe therefore that NGG NTS should seek to procure at least a proportion of its OM requirements on a long-term basis i.e. for periods of 10 years or more. Consistent with this approach, it would be helpful if NGG NTS were to publish a ten year forecast of its OM requirements.

Within section 4.2 of the consultation document, NGG NTS describes the current rights of pre-emption that it holds over capacity in the LNG storage facilities for OM purposes. In the event that the 2010 tender process demonstrates the existence of competition in OM services, we believe that it would be essential to remove such rights since their continuation would unfairly restrict NG LNGS's commercial freedom and potentially undermine any future OM tender processes.

In terms of the proposed timetable for the 2010 tender process, NG LNGS has a UNC obligation to publish its 2010 Annual Storage Invitation on the 1st March 2010. It is therefore essential that we know prior to that date what level of OM service will be required by NGG NTS at each of the LNG storage facilities in order that we can determine how much capacity to sell via our annual auction process.

Finally, with regard to the prospect for the future development of OM contestability, we note Ofgem's view (set out in its decision letter concerning the 2009 OM tender process) that "in relation to the provision of some locational services, the possibility of effective competition is still not apparent at this stage". This statement would appear to be supported by NGG NTS's assessment of the potential volume of OM that could be provided by the various types of service provider which is set out in section 4.2 of the consultation document. To the extent that the outcome of the 2010 tender process fails to demonstrate the establishment of OM contestability, it is our current intention to seek a review by Ofgem of the price control arrangements that currently apply to the LNG storage business so as to ensure that the business is provided with sufficient funding to meet its future regulatory obligations (including in respect of the Scottish Independent Undertakings) on a safe, reliable, sustainable and economic basis.

Yours sincerely

By e-mail

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