

**National Grid Transco's proposal to transfer
its Liquefied Natural Gas facility at Isle of
Grain to a separate NGT group company**

A consultation document

May 2003

Summary

National Grid Transco (NGT) has notified Ofgem that it wishes to transfer its Isle of Grain LNG facility to a non-regulated NGT group company. NGT's subsequent intention is to convert the facility into a LNG import terminal, with the first deliveries of LNG scheduled to arrive in January 2005.

The Isle of Grain facility is one of five LNG facilities at present operated by Transco LNG Storage (TLNGS). These facilities provide either transmission support or storage services, or a combination of both. The Isle of Grain facility provides a combination of both. At present, access to LNG services at all five LNG facilities is covered by Transco's Gas Transporters' licence and the provisions of Transco's network code. As a result, all five LNG facilities have been granted exemptions under section 19C of the Gas Act 1986 (as amended) from certain of the requirements pertaining to third party access obligations as contained in the Gas Act.

Ofgem's consent for NGT's proposal is required under Amended Standard Condition 29 (asset disposal) of Transco's Gas Transporters' licence. NGT has also identified that its proposal requires Ofgem's consent under Amended Standard Condition 47 of Transco's licence, and also a number of relevant changes to Transco's network code.

In principle, Ofgem is in favour of NGT's proposal and the subsequent development of an LNG import terminal at Isle of Grain. However, such a proposal has to be considered within the context of security of supply and competition issues, shippers' use of the present Isle of Grain facility, Transco's use of LNG services at Isle of Grain, and the basis on which Transco would make available NTS entry capacity to an import terminal.

Security of supply and competition could be expected to be enhanced by the transfer and conversion of the facility into an LNG import terminal. There would be a different and additional source of gas supply. Given that responses to a recent Ofgem consultation on the withdrawal of LNG capacity (including at Isle of Grain) received few responses, it is reasonable to assume that non-Transco customers of LNG services do not appear concerned by the eventual withdrawal of LNG storage services at Isle of Grain that would be the consequence NGT's proposal.

Transco's requirement for LNG services at Isle of Grain form part of Transco's Safety Case obligations. While any changes to the Safety Case are a matter for Transco and the Health and Safety Executive, a successful demonstration at Isle of Grain that these obligations can be met by contracting for LNG services (as opposed to owning and operating the asset) should enable the transfer of the remaining four LNG storage facilities. This would be supported by Ofgem.

Transco must ensure that the basis on which NTS entry capacity is priced and made available to the owner / operator of the import terminal is consistent with the way Transco makes such capacity available elsewhere on its system. This is even more so the case given that a non-regulated NGT group company will be the owner/operator of the import terminal.

While the application of the exemptions regime, either present or proposed, is not the aim of this consultation document, it is worth noting that the Isle of Grain facility has been granted an exemption under section 19C of the Gas Act from certain of the requirements of section 19D of the same Act. This exemption will have to be revoked and a new application made partly to reflect the change in use of the facility and partly as a result of the redrafted EU Gas Directive which will specifically cover new infrastructure such as LNG import terminals.

Comments are now invited on NGT's proposal for the transfer of the Isle of Grain facility and Ofgem's initial view in principle that the transfer is to be supported.

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1. Introduction

Purpose of this document

- 1.1. National Grid Transco (NGT) recently notified Ofgem that it sought Ofgem's consent under Amended Standard Condition 29 (disposal of assets) of its Gas Transporters' licence to transfer its Isle of Grain Liquefied Natural Gas (LNG) facility to a non-regulated (i.e. non-licensed), company within the NGT Group. NGT's subsequent intention is to convert the facility into a LNG import terminal.
- 1.2. This document seeks views on NGT's proposal so that such views can be taken into account when Ofgem decides whether consent should be granted.
- 1.3. This document does not seek to consult in detail upon the application of the redrafted EU Gas Directive with respect to the Isle of Grain as an import terminal, should consent for disposal be forthcoming. It would be Ofgem's intention to consult further as and when proposals for operation of the terminal are sufficiently well determined to progress such consultation.

Background

- 1.4. Transco's five LNG storage facilities are operated by a ring-fenced business unit within Transco called Transco LNG Storage (TLNGS). TLNGS is not a separate legal entity and provides access to the LNG facilities on network code terms.
- 1.5. These facilities are currently used both by Transco, in its role as the National Transmission System (NTS) Operator, and by shippers. In February 2002, Transco wrote to Ofgem giving notice of its intention to transfer all five LNG facilities to a non-regulated Lattice Group company in time for the 2003/04 storage year. This proposal would also have involved the subsequent conversion of the Isle of Grain facility into an import terminal. Ofgem declined to approve such a transfer until it had consulted on the proposal.
- 1.6. In July 2002, Ofgem therefore published '*Transco's proposal to transfer its Liquefied Natural Gas facilities to a non-regulated Lattice Group company. A*

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consultation document. Ofgem and NGT subsequently held a number of discussions regarding various aspects of the proposed transfer, for example, interpretation of statutory third party access requirements, Transco's requirements for LNG and the interaction with Transco's Safety Case (with the Health and Safety Executive (HSE), etc. These discussions have not yet been concluded.

- 1.7. In December 2002¹, Ofgem therefore notified the industry that LNG services for the storage year 2003/04 would be made available on network code terms. That is, the proposed separation of Transco's LNG facilities would not occur prior to the 2003/04 storage year.
- 1.8. On 25 March 2003, and subsequently on 8 May 2003, NGT put forward the present separation proposal relating to the Isle of Grain facility only and its subsequent conversion to an import terminal.

Outline of this document

- 1.9. Chapter 2 gives details of NGT's notice of disposal of the Isle of Grain facility and also information relating to Transco's other LNG facilities.
- 1.10. Chapter 3 outlines the regulatory framework with respect to LNG storage.
- 1.11. Chapter 4 provides details of NGT's proposed method of transferring the Isle of Grain facility.
- 1.12. Chapter 5 sets out Ofgem's views on NGT's proposal and invites respondents' comments.
- 1.13. Responses should be sent by 17 June 2003 to:

Kyran Hanks
Director, Gas Trading Arrangements
Ofgem
9 Millbank
London
SW1P 3GE

¹ "Transco's proposals to transfer its LNG facilities: update", Ofgem, December 2002
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or by e-mail to Kyran.Hanks@Ofgem.gov.uk

- 1.14. Where paper copies of a response are sent, it would be helpful if responses could also be sent electronically. It is open to respondents to mark all or part of their responses as confidential. However, we would prefer it if, as far as possible, responses were provided in a form that can be placed in the Ofgem library and on our website.
- 1.15. If you have any queries regarding this consultation, Kyran Hanks (020 7901 7021) or Amrik Bal (e-mail address Amrik.Bal@Ofgem.gov.uk, telephone 020 7901 7074) will be pleased to help.

2. NGT's notice of asset disposal and details of the proposed import facility

Notice of disposal of the Isle of Grain LNG facility

- 2.1. On 8 May 2003, NGT wrote to Ofgem to give notice of its intention to dispose of the Isle of Grain facility to a wholly owned subsidiary of NGT (the subsidiary will be a separate legal entity). This replaced NGT's earlier request, dated 25 March 2003, to dispose of the asset. NGT was obliged to give notice of such a disposal under amended standard condition 29 (2) of Transco's GT licence. This requires:

'Save as provided in paragraph 3, the licensee shall give to the Authority not less than two months' prior written notice of its intention to dispose of or relinquish operational control over any transportation asset or LNG storage asset, together with such further information as the Authority may request relating to such an asset or the circumstances of such intended disposal or relinquishment of control or to the intentions in regard thereto of the person proposing to acquire such asset or operational control over such asset.'

- 2.2. Transfer of the facility cannot therefore take place prior to 8 July 2003.
- 2.3. The Isle of Grain facility is one of five LNG storage facilities owned and operated by Transco. The LNG facilities are each directly connected to the NTS and are located at points that are, or were, at the extremities of the pipeline system: Glenmavis in Strathclyde; Partington in Lancashire; Avonmouth near Bristol; Dynevor Arms in South Wales; and Isle of Grain in the Thames Estuary.
- 2.4. The geographical location of the facilities in relation to the NTS entry terminals and the Rough & Hornsea facilities is shown overleaf (see figure 1). Details of the physical capacities of each of the LNG facilities are also provided (see table 1).

Figure 1 – Location of LNG facilities, NTS entry terminals and Rough & Hornsea

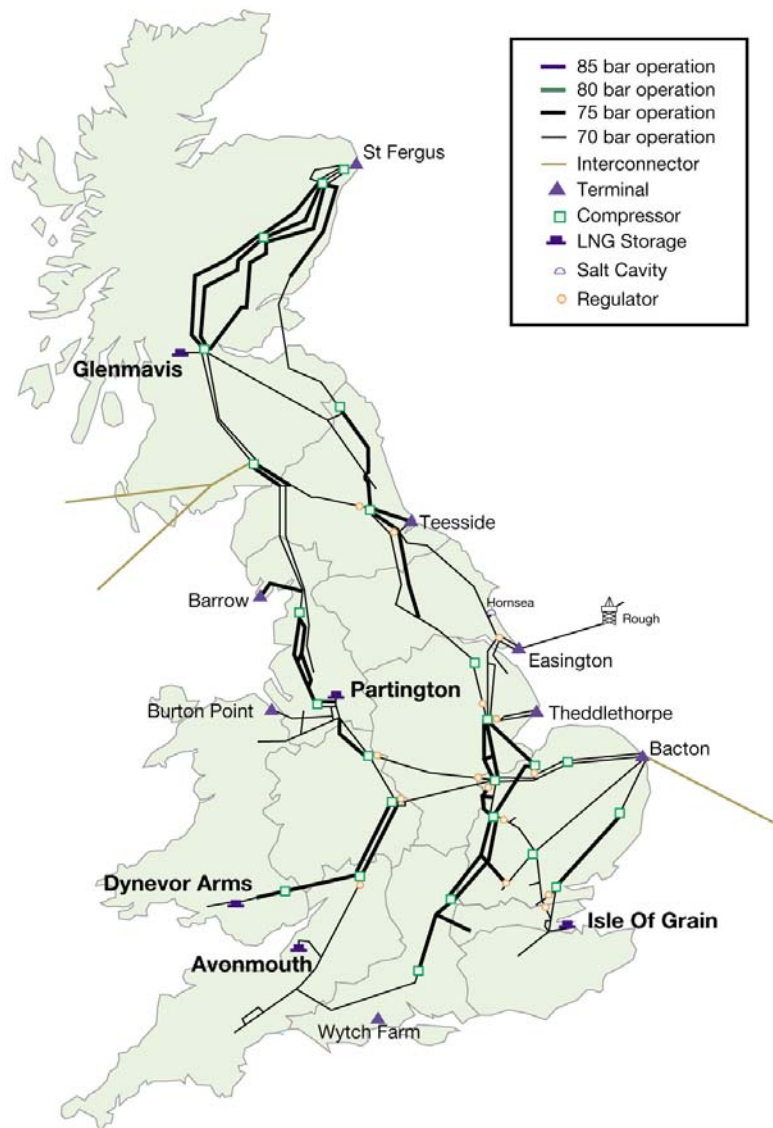


Table 1 – Summary of physical capacities 2003/4

Facility	Space (GWh)	Deliverability (GWh/d)
Avonmouth	876	156
Dynevor Arms	304	49
Glenmavis	507	101
Isle of Grain	563	186
Partington	1,122	220

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Details of the proposed LNG import terminal

- 2.5. NGT has proposed that were the disposal request granted, it would convert the present LNG storage facility at Isle of Grain into a LNG importation terminal.
- 2.6. The details of the proposed import terminal are as follows:
- ◆ Initial storage capacity: c. 2.1 GWh
 - ◆ Initial delivery capacity from the Isle of Grain LNG facility into NTS is planned to be 140GWh/day
 - ◆ Subject to market demand, the site offers the potential to provide additional capacity
 - ◆ NGT states that the first LNG imports are scheduled to arrive at the Grain LNG terminal (at the Isle of Grain, Kent) from 1st January 2005.

3. The regulatory regime

Ofgem's statutory obligations and duties

The Gas Act

- 3.1. The Gas Act 1986 (as amended), provides for the regulation of the onshore gas regime in Great Britain and for the separate licensing of Gas Transporters, Gas Shippers and Gas Suppliers. The Gas Act also imposes a number of obligations on the holders of such licences in addition to those in the licences themselves.
- 3.2. Section 28 of the Gas Act provides a method of enforcement (issuing provisional or final orders) to secure compliance with a relevant condition or requirement.

Transco's statutory obligations and duties

- 3.3. Transco has a number of statutory obligations and duties under both the Gas Act and under its GT licence. The licence includes Standard, Amended Standard and Special Conditions. Transco's Amended Standard and Special Conditions apply only to Transco and not to any other holders of a GT licence.
- 3.4. Sections 19C (Application of Section 19D to LNG facilities) and 19D (Acquisition of rights to use LNG facilities) of the Gas Act provide for statutory rights of negotiated third party access (TPA) to the LNG facilities. The Gas Act also provides for Ofgem to consider granting exemptions from certain of the TPA requirements if specified criteria contained in the Act have been satisfied. The present Isle of Grain facility, along with Transco's other four LNG facilities, has been granted an exemption on the basis that the network code provides for non-discriminatory access to the facility.
- 3.5. In summary, under sub-paragraph 1 of amended Standard Condition 4D (Conduct of the Transportation Business) of its GT licence, Transco is required to conduct its transportation business in the manner best calculated to secure that neither the GT or any affiliate or related undertaking, nor any gas shipper or gas supplier, obtains any unfair commercial advantage.

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- 3.6. Special Condition 9D (Restriction of prices for LNG Storage Services) of Transco's GT licence specifies the prices at which Transco will make available LNG services. Transco's purchases at these 9D prices are funded through its System Operator (SO) incentive allowances (due for review by April 2004). Any departure from these regulated prices requires Ofgem's consent. The first such derogation to depart from these prices – to facilitate the auctioning of capacity – was given in April 2000. Ofgem has granted a derogation to depart from 9D prices in each of the subsequent storage years prior to each year's LNG auctions. The current derogation for the 2003 / 04 will lapse on 31 March 2004. Note that the derogation applies only to shippers' use of LNG, not Transco's.
- 3.7. Standard Condition 41 (Prohibition of Cross-Subsidies) requires Transco to ensure that its transportation business shall not give or receive any cross subsidy to or from any other business of Transco or of an affiliate or related undertaking of it.
- 3.8. Amended Standard Condition 45 (Undertaking from Ultimate Holding Company) requires Transco to have procured from its 'ultimate controller', i.e. National Grid Transco, a legally enforceable undertaking in favour of Transco that National Grid Transco and any of its subsidiaries will refrain from any action that would be likely to cause Transco to breach any of its Gas Act or GT licence obligations.
- 3.9. In addition to the requirements of Standard Condition 29 (Disposal of Assets) and Special Condition 5 (Cross-Default Obligations), Amended Standard Condition 47 requires Transco to obtain the Authority's consent to create certain mortgages, charges, pledges, liens, or other forms of security or encumbrance (or undertake any indebtedness to any other person, or guarantee any liability or obligation of another person). Consent may also be required for certain types of transfer, lease, license or loan of any sums, assets, rights or benefits to an affiliate or related undertaking.
- 3.10. Transco's GT licence obliges Transco to prepare a network code, which sets out the arrangements between Transco and shippers for the use of, and connection to, Transco's pipeline system. Transco's network code was established in March 1996.

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- 3.11. In summary, under Amended Standard Condition 9 (Network Code), Transco is required to establish transportation arrangements which facilitate the achievement of the following objectives:
- a) the efficient and economic operation by the licensee of its pipeline system;*
 - b) so far as is consistent with sub-paragraph (a), the efficient discharge of its obligations under its licence;*
 - c) so far as is consistent with sub-paragraphs (a) and (b), the securing of effective competition between relevant shippers and between relevant suppliers; and*
 - d) so far as is so consistent, the provision of reasonable economic incentives for relevant suppliers to secure that the domestic supply security standards are satisfied as respects the availability of gas to their domestic customers.*
- 3.12. The terms of access to the LNG facilities are currently covered, although not exclusively, by Section Z of Transco's network code (other details can be found in TLNGS' Annual Storage Invitation (ASI)). These terms relate to the way in which both Transco and other users may contract for LNG services.

Competition legislation

- 3.13. The Authority has concurrent powers with the Director General of Fair Trading (DGFT) under the Competition Act 1998 and the Fair Trading Act 1973. In relation to these concurrent powers, the Authority works in conjunction with the Office of Fair Trading (OFT) under the terms of a concordat between the Authority and the OFT.

The Competition Act 1998

- 3.14. The Competition Act 1998 prohibits anti-competitive agreements and abuse of a dominant position. Chapter I prohibits agreements between undertakings, decisions by associations of undertakings or concerted practices which have the object or effect of preventing, restricting or distorting competition in the United Kingdom and which may affect trade in the United Kingdom.
- 3.15. Chapter II prohibits conduct by one or more undertakings, which amounts to the abuse of a dominant position in a market in the United Kingdom, which may affect trade in the United Kingdom.

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- 3.16. Under the Competition Act 1998 the Authority has the power to impose financial penalties of up to 10 per cent of UK turnover on companies found to be infringing the prohibitions of the Competition Act.

Fair Trading Act 1973

- 3.17. In general terms, the Fair Trading Act 1973 addresses monopoly situations. Where it appears to Ofgem that a monopoly situation exists or may exist, a reference may be made to the Competition Commission to investigate, broadly, whether such a monopoly is operating against the public interest. Undertakings may be accepted from relevant persons that are considered sufficient to deal with the adverse effects of the monopoly situation in lieu of a reference to the Competition Commission. Licence amendments may also be made in certain circumstances following a monopoly reference.

4. NGT's proposed method of transfer

- 4.1. NGT's notice of disposal also detailed both the way in which it proposed to effect the transfer of the facility from Transco plc to a non-Transco subsidiary of NGT, and the consents it considered were required from Ofgem. The notice is attached as appendix one.

Transfer mechanism

- 4.2. NGT envisages a similar mechanism for the transfer of this asset to that used for previous transfers (see appendix 1). NGT's intention is that Transco Holdings plc ("TH") will acquire the Isle of Grain asset from Transco plc ("Transco") for inter-company debt that is to be left outstanding. TH will immediately transfer the asset to its own holding company by "*dividend in specie*". Operation of the facility will remain under the control of Transco until all of the necessary exemptions, approvals and consents are obtained.

Consents required

- 4.3. NGT believes that based on the above structure, the following consents (described below) will be required.
- 4.4. Ofgem's consent under Amended Standard Condition 29 of Transco's Gas Transporters' licence to permit Transco plc to dispose of the Isle of Grain storage facility and to relinquish operational control. The condition permits automatic transfer if Ofgem omits to reply to Transco's disposal notice within 2 months, although NGT has indicated that they would prefer an affirmative consent from Ofgem. NGT has also explained that relinquishment of operational control will probably not occur until later (probably during 2004) but has also expressed the view that it is appropriate and, indeed, for the purposes of securing investment, necessary, to secure consent to both disposal and relinquishment of operational control, at this stage.

- 4.5. Ofgem's consent under Amended Standard Condition 47 of the Licence is required in a number of respects. Transco wants to transfer the asset in return for inter-company debt, which will be added to the long term inter-company debt balance and will not be interest bearing nor repaid. NGT does not think it appropriate, in these circumstances, for the debt to be guaranteed in accordance with the payment condition in paragraph 1(c) of Amended Standard Condition 47. Consent covering these aspects of this condition is requested.

Modifications to the Licence

- 4.6. NGT does not believe that any modification to the Licence is required and that the transfer of Isle of Grain storage facility from Transco plc to another entity automatically ends the application of the Licence to that facility. This is contemplated by the licence definitions of "LNG Storage Business"; which applies only to "...activities of the licensee ..." and "LNG Storage Facilities" which applies only to "...containers for the storage of LNG operated by the licensee ...".

Network Code modifications

- 4.7. In NGT's view, Transco's network code will require amendment to modify references to the Isle of Grain facility but not until later in the process. These will need to be effective from the date on which the facility becomes an import facility.
- 4.8. At present, Transco has identified that two separate modifications will be required to its network code. The first modification will remove Isle of Grain as a storage facility from the scope of the network code. This modification will have to be implemented before 1 March 2004 so that TLNGS does not have to sell a storage service at the Isle of Grain for storage year 2004/5 and beyond. The modification will include interim arrangements for part of storage year 2004/5 so that Transco can continue to use the storage facility for Operating Margins and Top-up purposes until the importation terminal commences commissioning.

- 4.9. The second modification will amend the Operating Margins and Top-up provisions of the network code such that Transco is able to obtain an Operating Margins and/or a Top-up service from entry facilities (including the Isle of Grain LNG importation facility) as well as from storage facilities. This modification will have to be implemented before the importation facility commences operation. Other interim modifications may be necessary to facilitate the transition from a storage facility to an importation facility, and these will be raised by Transco if and when necessary, but subject to Ofgem approval.

5. Issues for consultation

- 5.1. In Ofgem's view, NGT's proposal for the Isle of Grain facility needs to be considered in the light of:
- ◆ the impact on security of supply considerations and the overall benefit to competition in gas supply of an additional source and increased volume of gas into the UK
 - ◆ the impact of the withdrawal of LNG storage capacity currently provided by the Isle of Grain storage facility;
 - ◆ the impact on Transco's requirement for LNG services in its role as SO and the interaction of this requirement with its Safety Case; and
 - ◆ the basis on which NTS entry capacity would be made available to an import terminal at Isle of Grain

Security of supply

- 5.2. As UK Continental Shelf production declines and the UK becomes more dependent on imported gas, there will be an increasing need for new gas supply sources as well as investment in infrastructure projects to meet both the annual base load and the swing loads expected in winter.
- 5.3. The second report² from the Joint Energy Security of Supply working group (JESS), chaired jointly by the DTI and Ofgem, estimated that in 2010 (based on current estimates) the UK might have to import around half of its gas demand. By 2020 this estimate rises to over 80%.
- ◆ There are a number of potential options to resolve this situation, including:

² Joint Energy Security of Supply Working Group – Second Report, February 2003
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- ◆ liquefied natural gas (LNG) terminals to import gas from worldwide sources;
- ◆ more interconnection with Europe to import gas; and
- ◆ pipeline upgrades to existing interconnectors to increase import capacity.

Ofgem's view

- 5.4. In this regard, the development of an import terminal such as the one proposed by NGT could clearly be seen as positive step. It would not only add to the security of supply by bringing to market another source of supply but could also provide a competing and potentially valuable alternative to storage and interconnector flows. In addition to improving security of supply, the terminal could also improve diversity of supply as it would constitute a new import route into GB.

LNG storage capacity withdrawal

- 5.5. Shippers who book LNG storage do so because of its value as a balancing tool, especially on days of peak demand. Since 2000, TLNGS has made LNG storage capacity available via annual pay-as-bid auctions. The conversion of the LNG storage facility at Isle of Grain would clearly mean that the volume of capacity available to LNG Users for this purpose would be reduced.
- 5.6. However, TLNGS has in any case the ability under Section Z of Transco's network code to determine capacity levels - and hence the volume of capacity available for auction to LNG Users - at its LNG facilities. TLNGS exercised this right to determine capacity levels ahead of both the 2002 and 2003 ASIs.
- 5.7. As explained above, shippers will continue to have access to some LNG services under Transco's network code in the Storage Year 2003/4

Ofgem's view

- 5.8. Ofgem recently consulted on NGT's proposal to review the capacities at its LNG facilities of the 2003 ASI. At the Isle of Grain facility, NGT announced that TLNGS had determined that for both operational reasons and to allow preparatory work on conversion to an import terminal to begin, it would be necessary to reduce space capacity by 50%, injection capacity by 91%, and deliverability by 17%.
- 5.9. In our consultation, Ofgem sought views regarding the potentially negative impact that such a capacity reduction could have on LNG Users and prices at the other LNG facilities before deciding upon a possible course of appropriate action.
- 5.10. The relative lack of responses to that consultation suggests that shippers have little concern over the permanent reduction in capacity proposed by NGT. In that context, Ofgem does not think that the effective withdrawal of the remaining capacity at Isle of Grain should be considered a cause for concern. The volume that would effectively be withdrawn would represent a smaller volume than that referred to in the above consultation.

Transco's LNG requirements and its Safety Case

- 5.11. At present, Transco purchases LNG services for its Operating Margins and Scottish Independent Undertakings (SIUs) requirements. These purchases from TLNGS are made at regulated prices and funded through Transco's SO incentives. Transco is able to make its purchases ahead of other LNG Users. Transco will continue to have access to Operating Margins and Transmission Support services under Transco's network code until importation takes place and following commissioning as an import facility services will be provided under contract.
- 5.12. Transco, for GT licence requirements, is also able to access transmission support by 'constraining on' an LNG facility, ie. Transco can require that LNG users hold a minimum inventory of gas-in-store and to flow that gas when flow in the relevant LDZ reaches a set level known as the '*Demand Threshold Flow*'. In

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return for this, LNG users at a constrained storage facility receive a rebate on the transportation charges associated with holding gas in store over the peak winter period. Isle of Grain is currently such a constrained storage facility.

- 5.13. Transco's Safety Case with the HSE covers Transco's safe operation of its system and this includes the use that Transco makes of the LNG facilities. It may be the case that any proposal to transfer any LNG facility would require a change to the Safety Case. As such, NGT would have to obtain the consent of the HSE to such a change, and any concerns on the part of the HSE could therefore impact on NGT's proposal.
- 5.14. NGT has therefore recently submitted a proposed material change to its Safety Case but only in relation to the proposed change of use at the Isle of Grain facility. Ofgem understands that the HSE is at present assessing the proposed Safety Case changes.

Ofgem's initial view

- 5.15. The maintenance, agreement to change and compliance with Transco's Safety Case is properly a matter for Transco and the HSE (subject to consultation with Ofgem as appropriate). However, assuming that the HSE approves the necessary amendment to the Safety Case so that the transfer of the Isle of Grain can take place, Ofgem is of the view that (with respect to the Transco's Safety Case obligations) there is no reason why the same process and reasoning cannot be followed for the other LNG facilities.
- 5.16. If the transfer of the Isle of Grain facility can demonstrate that not having ownership and operational control of a constrained LNG facility does not hamper Transco in meeting its Safety Case obligations, then Ofgem would certainly expect prima facie the same arguments would be equally valid in relation to the other facilities.
- 5.17. NGT has agreed with the economic and commercial logic of Ofgem's view but is also cognisant of the difference, from a security of supply perspective, between a storage facility and an import facility.

NTS Entry Capacity rights

- 5.18. An import terminal would be an entry point onto the NTS in the same way as existing entry points. In that context, Transco will offer to sell capacity to shippers in a combination of long and short term auctions.
- 5.19. Ofgem's December update stated that Transco would publish and consult on indicative entry prices (i.e. Unit Cost Adjusters 'UCA's) for new entry points and supply an indicative supply curve for Isle of Grain. Following such consultation, Ofgem would formally consult on amendments to Transco's GT licence to introduce new UCAs, and any other consequential amendments (in the event that Ofgem consents to the transfer of Isle of Grain following this consultation process).
- 5.20. The UCAs are actually set by Ofgem and contained in the GT licence therefore any changes to the UCA would have to be proposed by Ofgem. Transco sets reserve prices in the auctions based on a methodology, which results in the charges related to the Ofgem UCA. Transco has stated this it would not expect these to be changed at Isle of Grain as a result of the change of use, and that the charges actually relate to the marginal cost of moving gas away from Isle of Grain, which is not affected by whether the entry point is a storage facility or an importation terminal.

Ofgem's initial view

- 5.21. Ofgem notes that under standard condition 41(Prohibition of Cross-Subsidies) of its GT licence, Transco is required to ensure that its transportation business shall not give or receive any cross subsidy to or from any other business of Transco or of an affiliate or related undertaking of it.
- 5.22. Ofgem considers that Transco must be particularly aware of this obligation when setting system entry charges, especially given the fact that an import terminal at Isle of Grain would be operated by a non-Transco company but in competition with one or more other LNG import terminals.

Summary

- 5.23. Clearly, the above issues could have a number of implications for the transfer of the Isle of Grain facility and its subsequent conversion into an LNG import terminal. These implications are of both a regulatory and operational nature. However, subject to respondents' views, Ofgem's initial conclusion is that the transfer and conversion of the facility into an import terminal is to be welcomed.

Associated Issues

The redrafted EU Gas Directive

- 5.24. A redrafted EU Gas Directive is planned to be implemented into UK law in summer 2004 and will replace the current Third Party Access (TPA) arrangements contained in Section 19 of the Gas Act. Although this is not an issue for consultation arising out of NGT's proposal, we consider that it would be useful to provide details at this stage of the Directive and how it might impact on an import terminal at Isle of Grain.
- 5.25. In relation to LNG facilities, the present wording of the redrafted Directive provides for default *regulated* third party access arrangements based on published tariffs. However, the redrafted Directive provides for owners of 'new' terminals to apply to the relevant authority in each member state for an exemption on a case-by-case basis from RTPA requirements for new infrastructure investments.
- 5.26. The redrafted Directive lays down a number of criteria that would have to be met for an exemption to be considered, namely:
- ◆ the investment would enhance competition and security of supply;
 - ◆ "the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted"
 - ◆ there is legal separation from the system operators (i.e. TSO's) in whose systems that infrastructure will be built;

- ◆ charges are levied on users of that infrastructure;
- ◆ the exemption is not to the detriment of competition or the effective functioning of the internal gas market, or the efficient functioning of the regulated system to which the infrastructure is connected;

5.27. Ofgem is the relevant authority in the UK under the present Directive and although it has yet to be determined that this will remain the case, the likelihood is that this Ofgem will be the relevant authority once the redrafted Directive is transposed into UK law.

5.28. As such, Ofgem's view is that the Isle of Grain's present exemption will have to be revoked before an application under the new Directive for an *import* facility can be considered. The facility would no longer be an LNG storage facility and nor would access to it be guaranteed under Transco's network code. However, any revocation of the present exemption will not take place prior to April 2004.

5.29. Ofgem and DTI intend to issue a paper on the likely regulation of LNG import terminals at the end of May.

Transco SO incentives review

5.30. As discussed above, Transco's use of its LNG facilities is funded through the SO incentives. These are due to be re-set in April 2004. This review is scheduled to begin in summer 2003. Transco has indicated that it would seek a review of the funding of the remaining LNG facilities as part of the SO incentives review.

Views invited

5.31. Ofgem invites views as follows:

- ◆ that the proposal for the conversion into a LNG import terminal is beneficial for additional volume and security and diversity of supply;
- ◆ to permit the withdrawal of Isle of Grain capacity; and
- ◆ that Transco's entry charges will not change as a result of the change in use of Isle of Grain

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5.32. Finally, Ofgem would welcome comments on any other aspect of NGT's proposal to the extent that it has not been covered in this consultation document.

Appendix 1

Date: 8th May 2003

Kyran Hanks
Ofgem
9 Millbank
London
SW1 P 3GE

Dear Kyran

Separation of Isle of Grain LNG Storage facility from Transco plc - Notification and request for Ofgem's consent

Further to recent discussions on this matter, I am writing, as requested, to withdraw NGT's prior notice and request for Ofgem's consent (dated 25th March 2003) and to issue a new notice and request for consent. The justification for this withdrawal and subsequent reissue is, as we have discussed, to give Ofgem sufficient time to consult on this matter whilst avoiding the need to issue a notice of objection to the 25th March 2003 notice and request. It remains Transco's intention to dispose of the Isle of Grain storage facility.

You will be aware from ongoing discussions that this matter has now become urgent from NGT's point of view. In order to meet the target completion date for the importation facility, investment decisions to finance the necessary construction work must be made in the very near future. The issue of Ofgem's consent is, of course, material to NGT's decision on whether or not to commit to capital expenditure. With this in mind, I would greatly appreciate a decision as soon as possible i.e. prior to the date of 8th July (as stated in this notice).

The following sets out what consents I believe are needed from Ofgem to enable the Isle of Grain LNG storage facility to be transferred out of Transco plc to a non- Transco subsidiary of National Grid Transco plc.

Transfer mechanism

We envisage a similar mechanism for the transfer of this asset to that used for previous transfers, including Project Schooner. Our intention is that Transco Holdings plc ("TH") will acquire the Isle of Grain asset from Transco plc ("Transco") for inter-company debt that is to be left outstanding. TH will immediately transfer the asset to its own holding company by dividend in specie. Operation of the facility will remain under the control of Transco until all of the necessary exemptions, approvals and consents are obtained.

Consents required

Based on the above structure, the consents described below will be required.

1. Ofgem's consent under Amended Standard Condition 29 of Transco's Gas Transporters' licence ("Licence") will be required to permit Transco plc to dispose of the Isle of Grain storage facility and to relinquish operational control. **Please regard**

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this letter as notice of Transco's intention to dispose of and relinquish operational control over the Isle of Grain LNG storage facility not earlier than 8th July 2003, pursuant to paragraph 2 of Amended Standard Condition 29 of the licence. The condition permits automatic transfer if Ofgem omits to reply to Transco's disposal notice within 2 months, we would however, prefer an affirmative consent by Ofgem. I should explain that relinquishment of operational control will probably not occur until later (probably during 2004) but it is appropriate and indeed for the purposes of securing investment, it is necessary to secure consent to both disposal and relinquishment of operational control, at this stage.

2. Ofgem's consent under Amended Standard Condition 47 of the licence is required in a number of respects. Consistent with the transfer mechanism used at Project Schooner, Transco intends to transfer the asset in return for inter-company debt which will be added to the long term intercompany debt balance and will not be interest bearing nor repaid. Further, it does not seem appropriate, in these circumstances, for the debt to be guaranteed in accordance with the payment condition in paragraph 1 (c) of Amended Standard Condition 47. Consent covering these aspects of this condition is requested.

We do not anticipate further consents under the licence being required. Please note however that the final arrangements for the transfer and service contracts are still to be agreed and if these change we may need to come back to you at a later date. We will let you know as soon as possible if we become aware that the position has changed.

Modifications to the licence

We do not believe that any modification to the licence is required and note that the transfer of Isle of Grain storage facility from Transco plc to another entity automatically ends the application of the licence to that facility. This is contemplated by the licence definitions of "LNG Storage Business"; which applies only to "...activities of **the licensee...**" and "LNG Storage Facilities" which applies only to "...containers for the storage of LNG **operated by the licensee...**". It would be helpful if you can confirm that it is also your view that no modification of the licence is necessary.

Network Code modifications

The Network Code contract will require amendment to modify references to the Isle of Grain but not until later in the process. These will need to be effective from the date on which the facility becomes an operational facility. Interim modifications may be necessary and if so we will let you have a modification proposal in due course which will of course, also require consent from Ofgem.

I understand that you intend, on receipt of this letter, to identify a legal resource in Ofgem to consider this issue. If it would be helpful to talk through the details of this then we would be pleased to arrange to meet with you. Please contact Sue Higgins directly on 0121 623 2252 to arrange this or if any further information relating to this matter is required.

Yours sincerely,

Tim Tutton
UK Director of Regulation
National Grid Transco

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separate NGT group company