

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

A decision document

July 2003

Summary

In May 2003, Ofgem published a consultation document seeking views on Transco's request to transfer its Isle of Grain facility to a non-regulated NGT group company (*'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). The facility would then eventually be converted into a LNG import terminal.

In the document Ofgem stated that its initial view was that the transfer should be permitted, partly because the development of an import terminal would not only add to the security & diversity of supply but also provide a competing and alternative to storage and interconnector flows. Nevertheless, Ofgem declined to approve the asset transfer until we had consulted with interested parties on its possible effects. In particular, we sought views on the following:

- ◆ that the proposal for conversion into an LNG import was beneficial for additional security & diversity of supply;
- ◆ that Ofgem should permit the withdrawal of the present LNG storage capacity at Isle of Grain;
- ◆ that Transco's NTS entry charges will not change as a result of the change in use of Isle of Grain; and
- ◆ other related aspects such as the redrafted EU Gas Directive and a review of Transco's System Operator (SO) incentives.

There were six responses to the consultation document, two of which were marked confidential. No respondent was against the proposed transfer or its eventual conversion into an import terminal (although the latter point was not actually part of the consultation *per se*).

There was widespread acceptance of Ofgem's view that the terminal could be expected to have beneficial effects with respect to the security and diversity of supply, as well adding to the competing alternatives to storage and the interconnector.

A limited number of comments suggest that the eventual removal of the remaining storage capacity for shipper bookings at Isle of Grain could have a negative impact on storage prices elsewhere. Additionally, this issue also brought comments that Transco

should have to contract for services at the import terminal in the same way as shippers. Ofgem's view is that the reduction in capacity is less than that which occurred prior to the 2003/04 storage year, and when shippers had previously been invited to comment on that reduction, there had been a very limited number of responses. In Ofgem's view, this indicated the lack of importance that shippers attached to what had been a *greater* reduction in capacity.

Respondents also commented that Transco should purchase its LNG requirements on the same basis as other parties, and this is something with which Ofgem agrees. The fact that Transco will be contracting for its LNG requirements at Isle of Grain (admittedly on a priority basis) could be viewed as helping to demonstrate that ownership & operation of the facility is not required to ensure the delivery of the necessary service. This could eventually lead to Transco contracting for such services in general on the same basis as shippers.

The extent to which Transco's continued priority access to services at Isle of Grain is consistent with the requirements of the redrafted EU Gas Directive could be open to debate. Clearly, this will have to wait until the Directive is implemented into UK law.

Ofgem would also like to address the comment made by two respondents regarding our view that the separation process followed for Isle of Grain could have implications for the remaining four LNG facilities. While Ofgem continues to believe that this remains the case, we do, of course, appreciate that there could be site-specific factors to take into account.

The forthcoming review of Transco's System Operator incentives should allow for concerns expressed regarding the transfer of what had been a price control-funded asset to be considered. The new incentives will be effective from April 2004.

Notwithstanding the above comments, Ofgem is of the opinion that on the basis of the consultation exercise, it would be appropriate to grant permission for the disposal as requested by Transco and detailed in our consultation document. However, in doing so, it should be noted that Transco has yet to obtain the required consent to amend its Safety Case and that it will also need Ofgem's approval of two related network code modifications.

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1. Introduction

Purpose of this document

- 1.1. This document presents Ofgem's decision on National Grid Transco's (NGT) proposal to transfer its Isle of Grain Liquefied Natural Gas (LNG) in the light of responses to the issues raised in our May 2003 consultation document '*National Grid Transco's proposal to transfer its Liquefied Natural Gas facility at Isle of Grain to a separate NGT group company*'.
- 1.2. This document also provides details of respondents' comments to the issues raised in Ofgem's consultation document as referred to above.

Background and process to date

- 1.3. 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, and sought Ofgem's approval under Standard Condition 29 (Disposal of Assets) and Amended Standard Condition 47 (Indebtedness) of its Gas Transporters' (GT) licence. 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.
- 1.4. In July 2002, Ofgem therefore published '*Transco's proposal to transfer its Liquefied Natural Gas facilities to a non-regulated Lattice Group company. A 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.

- 1.5. 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.
- 1.6. 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.
- 1.7. In May 2003, Ofgem published its consultation document seeking views on NGT's proposal for the Isle of Grain.

Outline of this document

- 1.8. Chapter 3 summarises respondents' views on the issues raised in Ofgem's May 2003 consultation document. The responses are summarised in the same order that the issues were raised, that is:
 - ◆ that the proposal for conversion into an LNG import is beneficial for additional security & diversity of supply;
 - ◆ that Ofgem should permit the withdrawal of the present LNG storage capacity at Isle of Grain;
 - ◆ that Transco's NTS entry charges will not change as a result of the change in use of Isle of Grain; and
 - ◆ other related aspects such as the redrafted EU Gas Directive and a review of Transco's System Operator (SO) incentives.
- 1.9. Chapter 4 considers Ofgem's initial views as contained in our consultation document in the light of respondents' views.
- 1.10. Chapter 5 gives details of Ofgem's decision on NGT's request to transfer the Isle of Grain facility.
- 1.11. Appendix 1 contains the list of respondents.

¹ "Transco's proposals to transfer its LNG facilities: update", Ofgem, December 2002
National Grid Transco's proposal to transfer its
Liquefied Natural Gas facility at Isle of Grain to a
non-regulated group company
Office of Gas and Electricity Markets

2. Background

- 2.1. This chapter outlines the regulatory and legislative framework under which Transco operates the Isle of Grain facility and the other four LNG facilities owned & operated by Transco LNG Storage (TLNGS).

Transco's statutory obligations and duties

- 2.2. 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.
- 2.3. 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 Transco's network code provides for non-discriminatory access to the facility.
- 2.4. 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.
- 2.5. 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 and was given with respect to prices charged to shippers. Ofgem has granted a derogation to depart from 9D prices with respect

to shippers' purchases 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.

- 2.6. 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.
- 2.7. 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.
- 2.8. 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.
- 2.9. 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.
- 2.10. 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.*
- 2.11. 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

- 2.12. 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

- 2.13. 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.
- 2.14. 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.

- 2.15. 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

- 2.16. 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.

3. Respondents' Views

Summary of issues

- 3.1. The May consultation document sought views on the following: that the proposal for the conversion into an LNG import terminal is beneficial for additional volume and security & diversity of supply; to permit the withdrawal of the Isle of Grain capacity; that Transco's entry charges will not change as a result of the change in use of Isle of Grain; and other related aspects such as the redrafted EU Gas Directive and the forthcoming review of Transco's SO incentives.
- 3.2. There were six responses to the above, two of which were marked confidential. Copies of the non-confidential responses are available from the Ofgem library. Three respondents were in favour of the proposal, while two respondents said that they were not opposed to the transfer of the facility. The remaining respondent did not specifically comment on whether it was in favour or not it was in favour but instead commented on a number of issues related to the proposal.
- 3.3. Respondents' views to the issues raised in our consultation document are summarised below.

Security and Diversity of Supply

Ofgem's initial view

- 3.4. 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.

- 3.5. Three respondents agreed that the proposed conversion of the Isle of Grain LNG facility into an import terminal could be expected to have a beneficial impact on the security and diversity of gas supplies. One of these respondents noted that other EU member states were also either building or proposing to construct similar import terminals for the purposes of augmenting their security of supply.
- 3.6. None of the remaining respondents stated that they felt that NGT's proposal would have a negative impact on security and diversity of supply issues.

The withdrawal of the Isle of Grain capacity

Ofgem's initial view

- 3.7. Ofgem suggested that the relative lack of responses to our consultation on the reduction of overall LNG capacity levels for the 2003/04 storage year suggested that shippers had little concern over the permanent reduction in capacity proposed by NGT. In that context, Ofgem did 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.
- 3.8. There were two respondents who commented on the specific issue of the potential impact of the withdrawal of the availability of LNG storage capacity for shipper bookings. In the view of one respondent, such a reduction would have an undesirable impact on prices at the remaining four LNG facilities. Such a view was also shared by the other respondent. This party also felt that the reduction in the previously available volumes of capacity would result in an increase in the cost of procuring system swing and that the increased cost of LNG imports would feed through to overall system transmission costs. For this reason, this respondent was of the view that access to the import terminal should be available to all shippers wishing to bring in an LNG tanker to market.
- 3.9. There were, however, other comments relating to the potential impact of the withdrawal of capacity, this time in the context of Transco's requirements for Operating Margins (OMs) and transmission support purposes.

- 3.10. One respondent expressed concern that following any transfer of the facility should Transco retain sole access to the remaining LNG storage capacity, this could represent a cross-subsidy, so there should be equal access rights between Transco and shippers to any remaining LNG storage capacity. This respondent also commented that if priority access were required by Transco for its security of supply obligations, this raised doubts as to whether the facility should be transferred.
- 3.11. Comments from three other respondents also referred to Transco's continued OM and transmission support requirements. In one case, the comment made was that Transco should have to purchase any OM / top-up services from the import terminal it should be able to demonstrate that such purchases were reasonable and efficient. Another respondent felt that Ofgem should monitor the extent of Transco's LNG purchases to ensure that shippers were not be disadvantaged with respect to the availability of remaining capacity, while the final respondent on this issue commented that Transco should only be able to enter into peak-shaving services having also spoken to other LNG import terminal operators.
- 3.12. The specific effect of the subsequent reduction in LNG storage on Transco's Safety Case was also raised by one respondent. In this case, this party commented that there could be unforeseen consequences arising from changes to Transco's Safety Case and that these could have commercial implications for the shipping community. In this instance, this respondent suggested that some form of limited disclosure of the Safety Case might be merited, whilst recognising that the Safety Case was a matter between Transco and the HSE.
- 3.13. This same respondent also commented that it disagreed with Ofgem's view that in terms of the transfer of Isle of Grain *'there is no reason why the same process and reasoning cannot be followed for other LNG facilities'*. This respondent was concerned that such a view did not take into account that there might be other issues relevant to the facility in question, depending upon the planned use of the facility in question. This view was shared by another respondent who commented that the possible transfer of the remaining four facilities would have to be looked at on a case-by-case basis and that no general conclusions could be drawn from the transfer of the Isle of Grain.

NTS Entry Charges

Ofgem's initial view

- 3.14. Ofgem was of the view that Transco must be particularly aware of its obligation condition 41(Prohibition of Cross-Subsidies) 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.
- 3.15. Comments on this issue were received from two respondents. One of these parties considered the auctions of NTS entry capacity to help provide an investment signal for Transco could create an unacceptable additional expenditure and risk for developers that, in all likelihood, jeopardise the economic viability of developing future facilities.
- 3.16. The other respondent who commented on this issue welcomed Transco's view that the level of Unit Cost Adjusters (UCAs) at Isle of Grain would not change as a result of the conversion of the facility into an import terminal. However, this party did ask whether Transco would have to purchase NTS entry capacity rights as result of purchasing OM and transmission support services at the new import terminal.

EU Gas Directive and other issues

Ofgem's initial view

- 3.17. Although any consideration of an exemption for the import terminal from the requirements of the redrafted EU Gas Directive was not a subject for this consultation, Ofgem noted that the present facility had been granted an exemption under the provisions of the present Gas Directive. As such, it was Ofgem's view that the Isle of Grain's present exemption would have to be revoked before an application under the new Directive (for the import facility) could 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 would not take place prior to April 2004. Ofgem understands that NGT is considering submitting a request to

re-apply for an exemption under the existing Section 19 C of the Gas Act to reflect the proposed change in use of Isle of Grain from a storage facility to an import terminal.

- 3.18. Only one respondent commented on this issue. In the view of that respondent, the import terminal should not be granted an exemption until it can prove that it has met the criteria laid out in the new Directive.
- 3.19. Another issue that three respondents commented on was the fact that NGT's proposal involved the separation and transfer of a price control-funded asset. In the view of two respondents, customers had contributed to the revenues for capital expenditure on this facility and, through the price control, the risk associated with expenditure had been minimised. As such, these respondents looked to a future Ofgem consultation regarding the effects of the transfer on Transco's SO incentives.
- 3.20. Another respondent who raised this general issue was of the view that the proposed method of transfer which involved the use of a 'non interest bearing loan' from the regulated business with no expected repayment date raised the concern that the financing costs of the commercial business might be subsidised by the regulated business. In order to prevent this, the loan should be treated within Transco's regulatory accounts as being interest bearing at an appropriate interest rate.

4. Ofgem's decision

- 4.1. Ofgem remains of the opinion that it is appropriate to permit the transfer of the Isle of Grain facility. However, in doing so, Ofgem would like to comment on several aspects of respondents' views.
- 4.2. Ofgem notes that of the six responses, none were against the proposal to transfer the facility, nor to then to convert it into an import terminal to be owned and operated by a non-regulated NGT group company (although this latter point was not part of the consultation *per se*). Indeed, we note that there was widespread agreement with Ofgem's initial view that an import terminal could be expected to contribute to the security and diversity of supply.
- 4.3. A number of issues were raised as part of this consultation, namely: the reduction in the volume of LNG storage capacity, both in the short term and also once the import terminal had been constructed; Transco's access to the remaining storage capacity for OM and transmission support requirements; the potential impact on Transco's Safety Case and implications for the remaining four LNG storage facilities; and the effects of the transfer on Transco's SO incentives.
- 4.4. As we made clear in our consultation document, the reduction in the availability of LNG storage capacity as the result of the transfer & conversion of the Isle of Grain facility is less than that announced prior to the 2003/04 LNG auctions. In that instance, there has been no increase in LNG prices, although that clearly cannot be seen as an indication of any future developments. Given that there was a very limited number of responses to Ofgem's invitation to comment on the capacity reduction ahead of the 2003/04 capacity reductions, and that as part of this consultation only two respondents commented on this issue, Ofgem remains of the opinion that the effective withdrawal of the remaining capacity at Isle of Grain is not a cause for concern. Moreover, it should be noted that under its network code, Transco has the ability to vary the volume of capacity made available to LNG users other than Transco.
- 4.5. Ofgem continues to believe that Transco can access its present OM and system support requirements under contract. Moreover, we believe that the fact that

Transco will have to contract for its future requirements at the import facility should demonstrate this point. However, in contracting for these services, Transco must bear in mind that it has a statutory obligation to develop an economic and efficient system, and also that it has a licence obligation 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 (Standard Condition 41 (Prohibition of Cross-Subsidies)). Clearly, these factors would have to be taken into account when contracting with a non-regulated NGT group company.

- 4.6. Another factor is that it is not yet possible to determine is whether Transco's proposed sole use of the remaining LNG storage capacity at the terminal is consistent with the Third Party Access (TPA) requirements of the redrafted EU Gas Directive. Nor is it yet possible to determine whether the way in which Transco proposes to contract for a 'deliverability service' once the import terminal has been constructed will be compliant with the Directive, given that it will involve volumes of gas-in-store and deliverability levels to which other users will not have access. Although Ofgem and DTI have already published draft guidelines on applications for exemptions from the Directive's TPA requirements², the exact nature of the application of the details of the Directive might have to wait until it is transposed into UK law next year.
- 4.7. Ofgem would also like to address the comments made in response to the view expressed in our consultation regarding the implications of NGT's proposal for the remaining four LNG facilities. Ofgem remains firmly of the view expressed in the consultation document that 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.'*
- 4.8. However, in making the above comment, Ofgem is not ignoring that other considerations would have to be taken into account with respect to the

² LNG facilities and interconnectors: EU legislation and regulatory regime – DTI / Ofgem initial views. A consultation document, June 2003

remaining facilities. In the context of the Safety Case, these might have to be considered on a site-specific basis.

- 4.9. Respondents expressed concern as to the value at which the assets will be transferred from Transco. One respondent thought that the transfer should be at a “market” valuation based on an auction process, rather than a “regulated” valuation. In this context, it is important to note that Transco is not obliged to conduct such an auction and also that as none of the LNG facilities forms part of Transco’s regulated asset base, there is no ‘regulated’ valuation as such (although the facilities do have a notional regulatory value based on the overall valuation of Transco’s assets largely set by the 1997 MMC Inquiry).
- 4.10. Ofgem sees no reason to change the so-called “unfocused” approach to the valuation of regulated assets contained in the 2002 price control (an approach itself based on the 1997 MMC Inquiry) and which was most recently used to allow the setting of a separate price control for Transco’s metering business. In this light we are content with the transfer of the Isle of Grain at its notional regulatory value.
- 4.11. Although the method of transfer with respect to the Isle of Grain facility is consistent with that used and permitted on previous occasions, Ofgem notes that a respondent expressed concern regarding a possible cross-subsidy from the Transco to a non-regulated NGT business. In that context, it should be noted that Ofgem would, of course, retain its powers to enforce Standard Condition 41(Prohibition of Cross-Subsidies) in the event Transco were in material breach of its obligations.
- 4.12. The forthcoming review of Transco’s SO incentives will consider every aspect of Transco’s role as the system operator.
- 4.13. In granting permission for the transfer of the facility, Ofgem would like to draw attention to the following:
 - a) Ofgem understands that the HSE has yet to permit the required change to Transco’s Safety Case; and

- b) the consultation document referred to two network code modifications that would have to be approved by Ofgem as part of the transfer process. One modification would be required such that Transco would not have to sell a storage service at Isle of Grain beyond the end of the 2003/04 storage year. Additionally, a further modification would be required so that Transco can continue to use the storage facility for OM and top-up purposes until the importation terminal commences commissioning. Both modifications would, of course, be considered by Ofgem in the same context as other modifications, ie. the extent to which they facilitated the relevant objectives.

Appendix 1 List of Respondents to the Consultation

- 1.1 The following parties responded to the May 2003 consultation document. Copies of these non-confidential responses can be viewed in Ofgem's library or on Ofgem's website (www.ofgem.gov.uk).

Shell Gas Direct

LE Group

Centrica

Petroplus Tankstorage International B.V

- 1.2 In addition to the above, there were a further two responses marked confidential.