

**Qatar Petroleum and Exxon Mobil:
Draft application for an exemption for the
South Hook LNG Import Terminal project at
Milford Haven**

Final views

February 2004

Table of contents

1. Introduction.....	1
2. Discussion of the request.....	3
Discussion of the exemption criteria.....	3
Conclusions	12
3. Way forward.....	13
Appendix 1	14
Appendix 2 : Respondents.....	21
Appendix 3 : Documents submitted to the European Commission	22

1. Introduction

- 1.1. In December 2003, Ofgem issued an initial views paper¹ on a draft application that had been received from Qatar Petroleum (QP) and Exxon Mobil (EM), for the proposed South Hook Liquefied Natural Gas (LNG) import terminal at Milford Haven. The draft application requested early informal non-binding guidance as to the likely regulatory treatment of the import terminal project pending new legislation arising from the recent Gas Directive. This document provides Ofgem's final views on this draft application, which have led to the letter sent to QP/EM on 10 February 2004, attached as appendix 1.
- 1.2. The QP/EM draft application was in the context of the documents issued jointly by the Department of Trade and Industry and Ofgem in June and November 2003.² These documents consulted and concluded upon the likely regulatory treatment of LNG import facilities and interconnectors under the recent Gas and Electricity Directives.
- 1.3. In these documents, we explained that the Directives would introduce a regulated third party access regime (RTPA) for interconnectors and LNG import terminals. The Directives, however, also allow for exemptions to be given by the relevant regulatory authorities from these RTPA provisions provided certain criteria are met. Such exemptions would be subject to modification or veto by the European Commission.
- 1.4. We explained that it is likely that the Directives will be in force in the UK in mid 2004 and that it was the intention of the DTI that the relevant regulatory authority would be Ofgem. The DTI has recently issued a consultation document on the implementation of the new Gas Directive.³ However, there are several potential LNG and interconnector projects that could be moving to financial close prior to the Directives becoming law.

¹ 'Qatar Petroleum and Exxon Mobil , Draft application for a Gas Directive exemption for the proposed LNG terminal at Milford Haven, Initial Views', Ofgem, December 2003

² 'LNG facilities and interconnectors: EU legislation and regulatory regime, DTI/Ofgem, Initial Views', Ofgem, June 2003 and 'LNG facilities and interconnectors: EU legislation and regulatory regime, DTI/Ofgem, Final Views', Ofgem, November 2003

³ 'Consultation Concerning Common Rules for the Internal Market in Gas', see

http://www.dti.gov.uk/energy/consultations/common_rule_gas.pdf

QP/EM: Draft exemption application for the Milford Haven LNG import terminal: Final views

Project developers have requested early informal non-binding guidance as to whether they could expect their particular project to be exempt from the RTPA regime. DTI and Ofgem indicated that Ofgem would be prepared to give such guidance. However, this decision would need to be informed by consultation on a case-by-case basis. Any such consultation would be on the basis of a draft application for exemption as prepared by the relevant infrastructure developer. We explained that formal exemption granting powers will only be available to Ofgem once the Directives have been enacted into UK law.

- 1.5. It was made clear that while Ofgem shall aim to ensure, as far as possible, that any early informal non-binding guidance that is issued gives comfort as to the likely regulatory treatment of particular infrastructure, any such guidance issued would also be constrained to a significant extent by necessary legal caveats.
- 1.6. It is also important to note that the new Directives have not yet been implemented into UK law and that any amendments to UK law which are made in order to do so may be different to those currently envisaged. The views set out in this paper may change if the requisite amendments to UK law prove to be different to those envisaged. Interested parties should not rely on this document for any purpose other than as guidance as to the way in which the new Directives may be transposed into UK law and views of how the new regulatory regime may operate.
- 1.7. Notwithstanding any early guidance issued and consultation surrounding such guidance, Ofgem would anticipate undertaking a formal consultation once it had obtained formal powers and the sponsors of the facility in question formally applied for an exemption.
- 1.8. There were three responses to the Ofgem initial views paper. Respondents are listed in appendix 2, and replies can be found on the Ofgem website.
- 1.9. If you wish to discuss any matters in this document, please contact Kyran Hanks on 020 7901 7021 or Amrik Bal on 020 7901 7074.

2. Discussion of the request

- 2.1. Ofgem's initial views document set out the arguments presented by QP/EM in its draft exemption application request as to why it considered that it met the various requirements of the Gas Directive. The initial views paper also set out why Ofgem was (based on the evidence available to it and subject to necessary legal caveats) minded to exempt the import terminal from certain requirements of the Gas Directive.
- 2.2. This chapter presents the views of the three respondents to the initial views paper and Ofgem's final views, which take into account those responses and further discussions with QP/EM and the European Commission respectively. The full list of documents supplied by QP/EM as part of its draft application is set out in appendix 3.
- 2.3. In general terms, there was support for the construction of the import terminal. One respondent supported QP/EM's application for an exemption, while another offered qualified support for some form of exemption (although not the full exemption requested by QP/EM). The final respondent concluded that it did not consider that QP/EM had satisfied all the exemption criteria and that further analysis was required.

Discussion of the exemption criteria

- 2.4. Views of respondents are summarised below. The views of Ofgem are contained in the letter to QP/EM included in appendix 1, but are summarised for convenience below.

(a) The investment must enhance competition in gas supply and enhance security of supply

Ofgem's initial view

- 2.5. Ofgem considered the impact of the South Hook terminal in a number of related markets.

- 2.6. With respect to upstream competition, the project could be expected to have a beneficial impact in that QP would be a new market entrant. As for EM, even after 30% of QP/EM volumes had been attributed to EM, EM's share of the upstream market was forecast to fall *overall* due to a decline in its share of UK Continental Shelf gas production (this situation would not change significantly even with the potential inclusion of 25% of Gasunie volumes).
- 2.7. We again took the view that as a new entrant to the wholesale market, the presence of QP could be expected to have a beneficial impact on competition. In principle, this conclusion would also apply with respect to EM assuming that EM did not further increase its share of the wholesale market by other means.
- 2.8. Ofgem's view was that on the analysis provided by QP/EM, the project would seem to enhance competition in gas supply, as well as enhancing security of supply (including diversity of supply).
- 2.9. A different conclusion might have been reached when taking into account EM's interests in Gasunie, its relationships with Royal Dutch / Shell, the lack of an open season and the nature of the contractual arrangements between Qatar Petroleum and EM.
- 2.10. One potential method of dealing with any remaining concerns could have been through the conditions attached to any exemption, or the circumstances in which any exemption could be withdrawn.

Respondents' views

- 2.11. One respondent believed that the South Hook project had satisfied this criterion and that it would therefore be good for competition (based on the assessment of competition at various stages along the supply chain).
- 2.12. Additionally, although an open season was an effective means of achieving transparent access arrangements, in the absence of such arrangements it was up to Ofgem to be satisfied as to the effect on competition.

- 2.13. A second respondent commented that spare capacity at the terminal should be made available to third parties. This respondent also thought that the import terminal might go some way to replace the reduction in EM's share of UKCS production. However, EM's 25% share in Gasunie should be considered in the upstream analysis. A final comment was to stress the importance of further Ofgem analysis before any deciding upon the exemption request.
- 2.14. The final respondent made a number of comments relating to this criterion.
- 2.15. First, it considered that UIOLI rules were important in ensuring that the import terminal could be used to the maximum benefit of the market. In that context, Ofgem should be aware of issues such as tanker design and size, the notice period required for capacity release to third parties, and potential LNG gas quality concerns.
- 2.16. Second, to ensure non-discriminatory pricing to the import terminal, QP/EM should be required to publish 'own use tariffs' as well as rates applicable for UIOLI services. Alternatively, Ofgem must have the ability to investigate potential cases of discrimination and inform the market accordingly.
- 2.17. Third, the lack of an open season was an area of concern. While it would be difficult to conduct an open season in respect of Phase 1 of the project, this respondent thought that there may be some merit in Ofgem satisfying itself that it was not possible to carry out such a process for Phase 2 of the terminal development.
- 2.18. A final point made by this respondent concerned the data provided in coming to our view regarding the impact on competition. In particular, the respondent stated that due to the size of the project and EM being the sole buyer, they would have expected EM's market position to have been enhanced.

Ofgem's Final Views

- 2.19. Ofgem remains of the view that in terms of upstream considerations, as a new entrant, the presence of QP could be expected to enhance competition.
- 2.20. This view also applies when considering the wholesale market. QP would be a significant new entrant to the market when taking into account its 70% ownership of the company selling gas out of the import terminal.
- 2.21. As for the downstream market, QP has no significant existing interests and this situation is not expected to change. However, it should be noted that QP's involvement as a new entrant in the upstream market can be expected to be good for downstream competition.
- 2.22. If 30% of the QP/EM volumes were attributed to EM, EM's share of the upstream market is still forecast to decline compared to the present figure. This remains the case even if we chose, on account of EM's 50% interest in NAM and 25% interest in Gasunie, to allocate to EM's upstream market share 4 bcm of the potential 8 bcm Gasunie sale of gas to Centrica.
- 2.23. In terms of the wholesale market, even if 100% of the gas flowing out of the terminal were allocated to EM, Ofgem's view is that EM's proportion of the wholesale market would still not be significant. This would remain the case even taking into account EM's 25% interest in Gasunie.
- 2.24. EM is not at present a significant supplier of gas to customers in the downstream market and is not proposing to supply the QP/EM gas directly to customers. Any effect on the downstream market, therefore, can be expected to be neutral.
- 2.25. Ofgem agrees that an open season would have been a beneficial factor in support of this application, and also on the importance of effective anti-hoarding arrangements. A failure in terms of the latter could lead to an exemption being modified.
- 2.26. With regards to the issue of the publication of tariffs, QP/EM has agreed to publish rates for third party and own use purposes.

- 2.27. Therefore, on the basis of the competition analysis presented by QP/EM in its draft application and Ofgem's own competition assessment, Ofgem is of the view that the project, when considered in isolation, is likely to meet this criterion. In particular, as the project would enhance the overall level of gas supply, this should increase competition to the benefit for customers, a benefit that would otherwise not have existed.
- 2.28. Moreover, gas in a new location could be expected to enhance security of supply, as could the fact that this gas would be from a new source.

b) The level of risk attached to the pipeline is such that the investment would not take place unless an exemption is granted

Ofgem's initial views

- 2.29. In our initial views document, Ofgem noted that it was content with the QP/EM view that the level of risk attached to the project would seem to merit exemption. This view was reinforced by the fact that the LNG market was still at a relatively formative stage and that it was therefore difficult to see how the attendant risks could be mitigated by anything other than some element of long term contractual certainty.
- 2.30. Although Ofgem stated that it would be seeking further details regarding the project financing, we expected that this criterion would be met.

Respondents' views

- 2.31. One respondent agreed with Ofgem's initial conclusion and pointed out that it considered it appropriate to consider the overall project risk and not just that associated with the construction of the terminal.
- 2.32. Another respondent, however, questioned whether 100% exemption from RTPA should be given to QP/EM for 25 years. In particular, this respondent pointed to the fact the project had not met relevant Ofgem criteria regarding all capacity being made available to the market; an effective UIOLI regime; and appropriate information gathering powers.

Ofgem's final views

- 2.33. As explained in our initial views, it is difficult to see how the risks associated with this project can be mitigated by anything other than some form of long-term contractual support. Having considered the views put forward by respondents, this remains our view.
- 2.34. Ofgem agrees with the need for UIOLI services. Consequently, we remain committed to ensuring that effective provisions are in place.
- 2.35. Therefore, in that context, on the basis of the analysis provided by QP/EM, and its financial advisors (Royal Bank of Scotland) and Ofgem's preferred approach to entrepreneurial projects presented in our joint consultation with the DTI, it appears appropriate to conclude that the level of risk attached to the South Hook import terminal is likely to merit exemption.

c) The infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built

Ofgem's initial view

- 2.36. Ofgem explained that it was clear that the terminal would be fully separate from National Grid Transco. On that basis, we expected this criterion to be satisfied.

Respondents' views

- 2.37. The two respondents who commented on this point both concurred with Ofgem's initial view.

Ofgem's final view

2.38. As noted above, this criterion is likely to be met.

d) Charges are levied on users of that infrastructure

Ofgem's initial view

2.39. Ofgem was content that on the basis that tariffs will be published, this exemption criterion is likely to be met.

Respondent's views

2.40. Two respondents commented on this point. One thought that it was for Ofgem to satisfy itself that own use charges are levied and appropriate, while the other respondent strongly supported Ofgem's comment regarding the necessity for the publication of tariffs.

Ofgem's final view

2.41. Ofgem does not intend ex ante to set or approve the applicable tariff structure. However, we remain of the view that tariffs for both third party and own use purposes should be published. QP/EM have agreed to such publication.

2.42. On that basis, Ofgem considers that this criterion is likely to be met.

e) The exemption is not detrimental to the effective functioning of the internal gas market, or the efficient functioning of the regulated system to which the infrastructure is connected

Ofgem's initial view

2.43. Ofgem considered that the connection of the South Hook terminal to the UK system would not be detrimental to the effective functioning of the internal gas market in the UK. In particular, NTS entry capacity will be booked consistent with entry capacity elsewhere on Transco's system and,

to the extent that there are any technical implications arising from the connection, eg. gas quality, we would expect these to be resolved by QP/EM and National Grid Transco. As such, we considered that this exemption criterion is likely to be met.

- 2.44. Ofgem also took the view that this project would be beneficial for the internal gas market in Europe as a whole. This view, however, was caveated with the recognition that Ofgem's remit was GB only.

Respondents' views

- 2.45. One respondent commented that QP/EM's European market analysis supported the view that the facility would not be detrimental to the functioning of the internal gas market. This respondent also commented on the need for the import terminal to sign standard (NTS) connection agreements before it would be able to concur with Ofgem's view that this criterion is likely to be met.
- 2.46. The other respondent who commented on this point put forward the view that while the relevant market share in overall European LNG terminal market terms would only be 10% this figure would be greater in the context of the GB market alone. As such, this respondent requested that Ofgem looks at the GB market share before determining that this criterion had been satisfied.

Ofgem's final view

- 2.47. Ofgem notes that the connection of the terminal will be on terms consistent with arrangements elsewhere on Transco's system. Additionally, the QGII project will increase the supply of gas to Europe in general, and UK in particular, and is not the only such project planned for UK.
- 2.48. Importantly, QP/EM say that the contractual arrangements being negotiated by QP and EM will not contain any destination or resale restrictions and will be consistent with law. In addition, the arrangements will not restrict either party from independent investment in the natural gas or LNG supply chain anywhere in GB or Europe.

- 2.49. Ofgem has therefore concluded that the project is likely to meet this particular criterion.

Scope of an exemption

- 2.50. In its initial views paper, Ofgem noted that QP/EM have requested that an exemption be granted for the full capacity of the terminal and for 25 years. Although we had no objection in principle to giving long-term exemptions, we did indicate a number of potential competition concerns arising from this project.
- 2.51. Possible ways of dealing with such concerns could involve an exemption for less than 25 years; an exemption for less than 100% of the capacity; a dispute resolution procedure; a mid-exemption formal review; or a requirement to construct extra capacity (on commercially viable terms) should this be requested by potential users.

Respondents' views

- 2.52. The responses on this point were mixed. One respondent believed that an exemption needed to be of a sufficient duration to ensure project viability. This respondent also went on to comment that provided QP/EM have made a convincing financial argument, a 25 year exemption should be supported.
- 2.53. The other two respondents, however, expressed some element of doubt as to the appropriateness of granting the exemption as requested by QP/EM. One specific comment queried the need for a 25 year exemption for both phases and whether such an exemption would allow for any future market changes to be taken into account. One solution, commented this respondent, could be for Ofgem to consider some form of partial exemption.

Ofgem's final view

- 2.54. Ofgem remains of the view that it would be appropriate to grant an exemption for the full duration of the contracts underlying the investment. However, we also remain of the view that the conditions for modification

or withdrawal of an exemption set out below should address the concerns expressed by some respondents.

- 2.55. The conditions for modification or withdrawal of an exemption, with respect either to QP and/or EM are:
- ◆ A material breach of exemption criteria;
 - ◆ A proven breach of EU or UK competition law;
 - ◆ Insolvency; and
 - ◆ Merger / acquisition activity of the sponsors or the terminal operating company that would have a material impact in relation to the terminal exemption.
- 2.56. In the case of a material breach of the exemption criteria or a proven breach of competition law it would be necessary to establish that such breaches had occurred and we would also envisage that an opportunity is provided to remedy breaches (that are capable of being remedied) before an exemption were withdrawn or modified. We propose to consider further the precise terms that will be appropriate for the above remedies.

Conclusions

- 2.57. On the basis of the application made by QP/EM, subsequent information provided by QP/EM and the views of respondents, Ofgem currently envisages granting an exemption as permitted under Article 22 of the Gas Directive. The exemption would be from Articles 18, 25(2) and 25(4) of the Directive.
- 2.58. An exemption from Article 19 is not necessary on the assumption that the storage part of the import terminal facilities at South Hook will not be regulated as is proposed in the DTI consultation document on Common Rules for the Internal Market in Gas. An exemption from Article 20 and 25(3) is irrelevant and an exemption from Article 25(1) is not permitted.
- 2.59. Ofgem proposes that the exemption will be for the entire capacity of the underlying contracts relating to both phases of the project.

3. Way forward

- 3.1. Ofgem sent the letter in appendix 1 to EM on 10 February 2004.
- 3.2. This final views document, together with all supporting documents has now been submitted to the European Commission (see appendix 3). We understand that they are also considering giving an early view (i.e. prior to implementation of the Gas Directive into UK law) on the Ofgem guidance.
- 3.3. As and when powers to exempt become available to Ofgem, we would expect formally to consult on the QP/EM proposal.

Appendix 1



Mr Ian Trickle
Europe Regulatory Advisor
Exxon Mobil Gas Marketing
St Catherine's House
2 Kingsway
PO Box 394
London
WC2B 5WG

*Bringing choice and value
to customers*

Direct Dial: 020 7901 7021
Email: kyran.hanks@ofgem.gov.uk

10 February 2004

Qatargas II LNG supply project: proposed UK LNG import terminal "South Hook" Informal application for exemption from regulated third party access

Thank you for your letter, on behalf of Qatar Petroleum and ExxonMobil Qatargas (II) Limited (QP/EM), of 27 November 2003. You have asked for Ofgem's views in relation to your draft application for exemption from certain requirements of the Gas Directive with respect to the South Hook LNG import terminal.

Process

The Department of Trade & Industry (DTI) and Ofgem explained our approach to the regulation of interconnectors and LNG import terminals in our November 2003 final views⁴ document. Inter alia, that document confirmed:

- ◆ the DTI's intention that Ofgem would be the relevant regulatory authority for new interconnectors and LNG import terminals;
- ◆ that Ofgem would be prepared to issue informal, non-binding, early guidance now to potential infrastructure developers as to the likely regulatory treatment of such infrastructure once the Gas Directive was transposed into UK law, likely to be July 2004; and
- ◆ a formal or legally binding exemption could not be awarded until Ofgem is given formal powers to do so.

We carried out an informal consultation in relation to your draft application in December 2003. Our views have taken into account the views of respondents where appropriate. We have also discussed the draft application with the European Commission and this letter has been copied to the Commission, as well as the DTI. To be clear, discussions with the European Commission should not be taken as any guide that the Commission agrees, or disagrees, with the views expressed by Ofgem in this letter. This letter is also included in Ofgem's final views on the QP/EM application, which will be published shortly.

⁴ This final views document resulted from a consultation document issued in June 2003
QP/EM: Draft exemption application for the Milford Haven LNG import terminal: Final views
Office of Gas and Electricity Markets

QP/EM have provided answers to further questions from Ofgem. You have also provided a significant amount of information, on a confidential basis, explaining the underlying economics of the project.

Conditions relevant to Ofgem's view

Before turning to the substance of your draft application, it is important to state the caveats that must be associated with our views. It was made clear in the DTI/Ofgem November 2003 final views document that we shall aim to ensure, as far as possible, that any potential guidance that is issued gives comfort as to the likely regulatory treatment of particular infrastructure. However, we also made clear that any such guidance issued would also be constrained to a significant extent by necessary legal caveats. Appendix 1 to this letter sets out the legal caveats associated with our views.

Exemption criteria

We have approached your draft application as though the new Gas Directive was in force in UK law today. On that basis, our view as to the draft QP/EM application is as follows.

(a) The investment must enhance competition in gas supply and enhance security of supply

With respect to the enhancement of competition, you have included with your draft application a qualitative analysis of the UK market. Ofgem has considered and agrees with the analysis put forward by QP/EM.

You have also included a quantitative analysis of the effect on competition of the QP/EM project. In line with the structure suggested by Ofgem, you have considered the competitive effect on upstream, wholesale and downstream competition. You explain that QP will be a new entrant to the British market. Even on the narrowest measure, QP's upstream market share does not rise above 12%. As for EM, you say that:

- ◆ at the wholesale level, on the most conservative basis, EM's market share remains at current levels, and that in your view of the market, the market share of EM never rises above 5%; and
- ◆ at the upstream level, even on the most narrow market definition, at no level (including infrastructure) can EM's interests have an appreciable effect on competition.

You conclude that the QGII project enhances competition at the upstream and wholesale levels of the supply chain in Great Britain, and is not to the detriment of competition at any other level.

The current views of Ofgem are given below.

Qatar Petroleum

With respect to upstream competition, QP is a significant new entrant to the UK upstream market and thus can be seen as beneficial to competition. With respect to competition in the wholesale market, QP appears as a significant new entrant through its 70% interest in the company which will be reselling gas out of the terminal to ExxonMobil.

As for downstream competition, it is clear that QP does not have significant downstream interests in the GB gas supply market. This position is not forecast to change as a result of the project. With respect to the market share of QP, Ofgem considers that the project will not have a negative effect on downstream competition. However, the presence of a competitive upstream sector is clearly important with respect to the supply of gas to UK customers. In that sense, the addition of a major new player in the upstream market is considered by Ofgem to result in an enhancement of downstream competition.

ExxonMobil

We have considered EM's position upstream. In our initial views document, we explained that when 30% of QP/EM volumes are attributed to ExxonMobil, its market share of upstream production is still forecast to decline compared to today. In this context, we would conclude that the South Hook project should increase upstream competition with respect to ExxonMobil, when compared to today, on the basis of the information available to us.

We have also considered ExxonMobil's interests in the Dutch gas market given the Gasunie contract to supply 8bcm / year of gas to Centrica from 2006 or 2007. You have explained that ExxonMobil owns 50% of N.V. Nederlandse Aardolie Maatschappij (NAM). The other 50% is owned by Royal Dutch / Shell and they are also the operator of NAM. NAM has an interest in a number of small fields as well as the Groningen gas field (in which it holds a 60% share). NAM in turn sells gas to Gasunie, which is itself 25% owned by ExxonMobil. Hence, in terms of upstream analysis, we have chosen to assume that 4bcm of gas could be allocated to ExxonMobil (accepting that this is the most conservative in terms of EM's interest in NAM). While this assumption increases the projected market share of EM, it is still the case that EM's market share is less than it currently is. On this basis, we conclude that upstream competition is enhanced.

We have considered EM's wholesale position. In the initial views document, we considered that QP should be considered as a new entrant to the wholesale market given its sales to EM. In respect of 30% of volumes, we considered that competition in the wholesale market would seem to be improved by the connection of the South Hook LNG terminal. We have not changed our view with respect to this analysis. Since the initial views consultation, we have considered a number of alternative scenarios including the effect on the wholesale market if 100% of the South Hook volumes were under the control of EM. This scenario, in our view, merited analysis given that EM will buy 100% of the volumes supplied by QGII through the terminal. If we assumed that the wholesale market included all sales and resales of gas (given that EM is not a significant trader) EM's proportion of the wholesale market, before and after the sale to EM, is still not significant. Alternatively, an even narrower assessment could be made on the assumption that the wholesale market is only physical. In that scenario, if we were to treat EM's purchase of the QGII volumes as the relevant transaction, the addition of 100% of the gas coming out of the South Hook terminal would result in an increase in EM's share of the wholesale market but not to a level that is detrimental to competition. In any event, Ofgem's view is that the level of wholesale liquidity should lead towards the first scenario.

While EM has stated that it does not control Gasunie we have, nevertheless, considered ExxonMobil's 25% interest in Gasunie. If the wholesale market is assumed to include all reported volumes, this minority interest in Gasunie does not significantly change the position of EM. However, if only physical positions were taken into account, this would again result in an increase EM's share at the wholesale level but, again, not to a level that is detrimental to competition.

We have considered the downstream impact of the QP/EM project. EM has no significant supply volumes to customers. They are not proposing to supply the QP/EM gas directly to customers. On that basis, the effect on downstream market shares is neutral.

In the initial views consultation, we highlighted four areas that would need to be explored. First, we considered the extent to which the QP/EM contractual arrangements might, or might not, provide ExxonMobil with control over gas flows. We have not at this point seen the contracts proposed by QP/EM. As such, we have not yet concluded consideration with respect to this issue. However, we consider that EM can plausibly be assumed to have control over the gas that they are contracting to buy. Our analysis above therefore assigns 100% of the volumes to EM.

Second, we considered EM's interests in the Dutch market, given the Gasunie contract to supply gas to Centrica. Our conclusions (including extreme case analyses) are included in the analysis given above.

Third, we considered the extent of EM's joint ventures with Royal Dutch / Shell. You provided information with respect to these joint ventures. You explained that the joint operating agreement in existence between ExxonMobil and Royal Dutch / Shell applies to some jointly owned oil and gas fields. You explained that ExxonMobil and Royal Dutch / Shell market production from your UK interests separately, and as such, the operating agreement has no impact on EM's upstream oil and gas sales. These arrangements have been in place for a considerable period of time, and to date, there has been no evidence of any related issues arising in the UK. However, EM has expressed a willingness to provide further information that we intend to review. In addition, any subsequent collusive action by EM and Royal Dutch / Shell that relied, in part, on the use by EM of the South Hook terminal, would be subject to investigation under general competition law.

Fourth, we considered the proposed anti hoarding arrangements. At this point, such arrangements appear appropriate. However, we intend that failure of such arrangements to offer unused capacity to market would enable the exemption to be modified.

The DTI and Ofgem have explained that an open season for expressions of interest in the terminal would help to demonstrate that an infrastructure project did enhance competition in gas supply. The decision of QP/EM not to undertake an open season is a negative factor in our consideration of the QP/EM draft application.

Another aspect in our competition assessment is the ability of the project to significantly affect gas flows in the UK. As such, the project should also enhance competition with respect to transportation services provided by, and purchased by, Transco.

You will see that our competition analysis has been extensive. In summary however, Ofgem concludes that, in the round, the project should be considered as beneficial for competition.

The second part of this criterion relates to security of supply. Ofgem considers that the addition of a new source of gas (i.e. Qatar) should be beneficial for security of supply. In addition, the location of the gas (South Wales) should be beneficial for diversity of supply.

The criterion in the Gas Directive requires that competition and security of supply are enhanced by this project. At this stage, we envisage that the QP/EM application should meet the requirements of this criterion.

b) The level of risk attached to the pipeline is such that the investment would not take place unless an exemption is granted

You have explained that for the entire LNG project to be viable, it is essential that QP/EM can secure, in advance, long term terminal access. You have provided the views of your financial advisors that exemption from certain aspects of the Gas Directive is necessary to ensure such long term access. You also explain that an exemption is required for 100% of the capacity for 25 years.

We are content with the QP/EM view that the level of risk attached to the entire LNG project is significant. As explained in our initial views, it is not easy to envisage how risks associated with the project can be mitigated other than through some form of long term contractual support.

On the basis of the analysis provided by QP/EM, and its financial advisors, Royal Bank of Scotland, and Ofgem's preferred approach to entrepreneurial projects presented in our joint consultation with the DTI on the regulation of LNG and interconnectors, it appears appropriate to envisage that the level of risk attached to the terminal would merit an exemption.

c) The infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built

It is clear that the South Hook terminal, QP, EM and the QP/EM companies are all separate from National Grid Transco. As such, we envisage that this criterion should be met.

d) Charges are levied on users of that infrastructure

QP/EM explained that it does propose to publish charges for third party, but not own, use. Ofgem considers that QP/EM should also publish charges for own use. QP/EM has agreed to this and on that basis, Ofgem would expect this criterion to be met.

e) The exemption is not detrimental to the effective functioning of the internal gas market, or the efficient functioning of the regulated system to which the infrastructure is connected.

You have explained that the QGII project will increase the supply of gas into Europe in general and the UK in particular, providing a reliable alternative to existing and projected sources of (mainly) piped gas. As such, existing continental European gas supplies will not be required for the UK, thereby increasing supply in other member states. You also explain that the contractual arrangements being negotiated by QP and EM will not contain any destination or resale restrictions. As such, you conclude that the project is not detrimental to the effective functioning of the internal market. We agree with your analysis.

You explain that, with respect to the UK, the connection of the terminal will be consistent with existing transmission specifications and entry capacity arrangements. We agree with your analysis.

Withdrawal of an exemption

We can confirm the grounds on which an exemption, once granted, could be expected to be modified or withdrawn. These are with respect to QP and / or EM:

- ◆ A material breach of exemption criteria
- ◆ A proven breach of EU or UK competition law
- ◆ Insolvency
- ◆ Merger / acquisition activity of the Sponsors or the terminal operating company that would have a material impact in relation to the terminal exemption

In the case of a material breach of the exemption criteria or a proven breach of competition law it would be necessary to establish that such breaches had occurred and we would also envisage that an opportunity is provided to remedy breaches (that are capable of being remedied) before an exemption were withdrawn or modified. We propose to consider further the precise terms that will be appropriate for the above remedies.

Next steps

We understand that the European Commission is considering providing a view as to the guidance issued by Ofgem in this letter. In that light, we have sent this letter, with all necessary supporting documentation, to the European Commission.

From our initial discussions with the European Commission, it is clear that they have some concerns with respect to the QP/EM application. Ofgem (and the DTI) will be arguing the merits of the QP/EM application to the Commission.

Summary

We have explained above Ofgem's current view as to the QP/EM draft application for exemption from certain aspects of the Gas Directive. We have concluded that the application by QP/EM meets each of the criteria set out in the Gas Directive. As a result, Ofgem currently envisages granting an exemption from certain aspects of the Gas Directive for the capacity of the underlying contracts that will underpin the construction of the South Hook terminal. We would currently expect to grant exemption for the full duration of the contracts underlying the investment.

Yours sincerely



Kyran P Hanks
Director, Gas Trading Arrangements

APPENDIX 1

Conditions relevant to Ofgem's view

This letter is limited by the fact that Ofgem currently has no legal vices to grant any exemption. As such, any informal early guidance given by Ofgem at this stage cannot legally bind Ofgem as and when a formal application for an exemption is made by QP/EM. This letter is not intended to create any rights or expectations enforceable in a court of law or to fetter the discretion of Ofgem in any way in the discharge of its functions.

Once formal powers to exempt are available to Ofgem, we would formally consult on your application. The responses to any such formal consultation may lead Ofgem to arrive at a decision, which is different from the informal early guidance given in this letter, to the extent that such responses revealed material new information.

The informal early guidance set out in this letter may need to be revised if the market conditions which are in existence at the time of your formal application for exemption are materially different from those in existence today or currently expected to exist at the time of your formal application.

Any exemption granted by Ofgem will be subject to veto by the European Commission. The informal early guidance set out in this letter may not therefore be applicable if the European Commission should come to a different conclusion.

In providing this letter, Ofgem is not exercising its concurrent powers under the Competition Act 1998. Consequently, this letter is without prejudice to such powers and to any other approval, exemption or clearance, which may be required under EU or UK competition law.

This letter is based on the assumption that the information provided to Ofgem is accurate and does not have any misstatements or omissions which may be material to Ofgem in considering this draft application.

Appendix 2 : Respondents

- 2.1 Non-confidential responses to the December 2003 consultation document were received from the following parties. Copies of these responses can be viewed in Ofgem's library or on Ofgem's website (www.ofgem.gov.uk).

Centrica

EDF Energy

National Grid Transco

- 2.2 There were no confidential responses to the December consultation document.

Appendix 3 : Documents submitted to the European Commission

1. *'ExxonMobil and Shell's Joint Activities in Natural Gas in Europe'* (24 October 2003) – an EM letter to Ofgem
2. Letter from Royal Bank of Scotland on the financing considerations (24 October 2003)
3. Public version of QP/EM draft application (27 November 2003)
4. Confidential version of QP/EM draft application (8 December 2003)
5. EM's response to European Commissions' questions (17 December 2003)
6. *'The structure of NAM and the relationship to Gasunie'* (14 January 2004) – an EM letter to Ofgem
7. Briefing paper on EM's interests in the Rovigo LNG import terminal in Italy (20 January 2004) – supplied by EM.
8. Ofgem's final views - letter to European Commission (10 February 2004)
9. Ofgem's final views - letter to EM detailing (10 February 2004)
10. Ofgem Final Views document (18 February 2004)