Dragon LNG Limited
Draft application for an exemption from Regulated Third Party Access Provisions of the Gas Directive

Ofgem Initial Views

April 2004

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1. Introduction

1.1. In June 2003, the Department of Trade and Industry (DTI) and Ofgem issued a joint consultation document, *"LNG Facilities and interconnectors: EU legislation and regulatory regime, DTI / Ofgem initial views"*. In that document, we explained that the forthcoming EU Gas and Electricity Directives were to introduce a regulated third party access regime (RTPA) for interconnectors and Liquefied Natural Gas (LNG) facilities, including LNG import terminals. The Directives allow exemption from RTPA to be given by the relevant regulatory authorities, subject to veto by the European Commission. The Directives set down criteria that have to be met in order to justify an exemption being granted.

1.2. In the June document, Ofgem and DTI explained that it is likely that the Directives will be given legislative force in the UK in mid 2004 and that it was the intention of the DTI that the relevant regulatory authority to administer the licensing and exemption regimes applying to interconnectors and LNG facilities would be Ofgem.

1.3. At this time there are several potential projects that could be moving to financial close prior to the Directives becoming transposed into UK law. Project developers have requested early guidance as to whether they could expect their particular project to be exempt. Ofgem indicated that while it would be prepared to give such guidance, we 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 prepared by the relevant infrastructure developer. Of course, formal exemption granting powers will only be available to Ofgem once the Directives have been enacted into UK law.

1.4. In November 2003, the DTI and Ofgem issued final views in relation to the new Directives and the regulatory regime proposed to give the new Directives legislative force.[1] By and large, the final views document confirmed, and clarified, the position set out in the initial views document.

1.5. Once legislative authority is granted to Ofgem in respect of the licensing and exemption of interconnectors and LNG facilities, Ofgem would expect to

[1] *'LNG facilities and interconnectors, EU legislation and regulatory regime, DTI / Ofgem final views,'* DTI / Ofgem, November 2003

undertake a formal consultation process in respect of formal applications it receives for exemption. This is notwithstanding any early guidance issued and consultation surrounding such guidance.

1.6. Ofgem has already consulted and issued decision documents on two informal exemption applications. The first was from Gastransport Services (GTS) for the proposed Balgzand Bacton pipeline project (BBL).[2]

1.7. The second application was received from Qatar Petroleum and ExxonMobil for the proposed South Hook LNG import terminal at Milford Haven in Wales.[3]

1.8. This document presents Ofgem's initial views on Dragon LNG Ltd's exemption application. Respondents' views are invited by 30 April 2004 and should be sent to :

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If you wish to discuss any matters in this document, please contact Amrik Bal on the number indicated above or Kyran Hanks on 020 7901 7021.

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[2] *'Gastransport Services, Draft application for an exemption for the Balgzand Bacton Pipeline project (BBL) Initial Views'*, Ofgem, September 2003 and *'Gastransport Services, Draft application for an exemption for the Balgzand Bacton Pipeline project (BBL)', Final Views,* Ofgem, December 2003.

[3] *'Qatar Petroleum and ExxonMobil Draft Gas Directive Exemption Application for an LNG Terminal at Milford Haven, Initial Views'*, Ofgem, December 2003 and *'Qatar Petroleum and ExxonMobil Draft Gas Directive Exemption Application for an LNG Terminal at Milford Haven, Final Views'*, Ofgem, February 2004.

2. Discussion of the request

2.1. Dragon LNG Ltd is owned by Petroplus Tankstorage International (Petroplus). Since it was established 10 years ago, Petroplus has developed interests in the European midstream oil market, encompassing refining, marketing and logistics.

2.2. Petroplus has built up a pan-European portfolio of activities. It is the owner of refineries in Antwerp (Belgium), Cressier (Switzerland) and Teesside (United Kingdom) with a total capacity of 270,000 barrels a day across the three refineries.

2.3. Petroplus does not currently have any activities in the natural gas industry and the development of the Dragon LNG import terminal will see it become a new entrant in the natural gas business.

2.4. This chapter summarises the main details of Dragon LNG Ltd's draft exemption request; the relevant conditions for an exemption; Dragon LNG Ltd's arguments as to how they meet these conditions, and Ofgem's initial views.

The exemption request by Dragon LNG Ltd

2.5. Dragon LNG Ltd is planning to construct an LNG importation and regasification facility at Milford Haven. Following an open season and negotiation between Petroplus and a number of interested parties, capacity in the facility has been sold to BG Group and Petronas.

2.6. Dragon LNG Ltd is currently in negotiations with both BG and Petronas for the purpose of signing agreements, referred to as Throughput Agreements with each and expects to sign binding contracts with each of the parties in late 2004. Further, BG has secured the agreement of Petroplus to invest in the facility as an equity holder by purchasing 50% of the shares in Dragon, while, in a separate agreement, Petronas has negotiated to purchase 30% of the equity in Dragon.

2.7. The facility will include some of the assets of the existing Milford Haven site in South Wales. New construction will include:

- new unloading facilities;

- an initial two cryogenic tanks (each of 160,000m^3) and regasification unit;
- planning permission for a third cryogenic tank was received in February 2003. Planning consent is currently being developed for a fourth tank.

2.8. It is Dragon LNG Ltd's intention to build the facility in at least two phases. The first phase consists of 6bcm of capacity (split equally between BG and Petronas) which will be available in late 2007. The second phase will also consist of a further 6bcm of capacity. BG and Petronas have each been granted an option for part of this capacity. Both BG and Petronas are limited to exercising their respective options within a specified, confidential time limit (which has been notified to Ofgem) and, as such, no date has yet been set for the completion of the second phase.

2.9. Dragon LNG Ltd is of the view that an exemption from RTPA requirements is necessary if the project is to proceed on its current schedule to deliver LNG to the UK. Dragon LNG Ltd is confident that the relevant authorities will be satisfied that the project should be exempt. That is, that exemption from the provisions of the Gas Directive is necessary in order that the project proceed. To support this view, Dragon LNG Ltd has prepared a document explaining why, in their view, exemption should be given. Part of this submission is confidential. However, the majority of the submission has been prepared for public consultation and is issued with this document.

2.10. BG Group[4] is a leading gas company with activities in over twenty countries. Its principal businesses are the exploration and production of gas and oil, liquefied natural gas, transmission and distribution, and power generation.

2.11. The company's major business segments include exploration and production; transmission and distribution; power generation; and LNG.

2.12. BG's LNG business combines the development and use of LNG import and export facilities with the purchase, shipping and sale of LNG and regasified natural gas. The company has been involved in developing LNG projects in Trinidad & Tobago, Egypt, Italy, India, Bolivia and Iran. BG currently has

[4] Not to be confused with British Gas, which is a trading name of Centrica plc in Great Britain, and not connected to BG Group.

interests in three LNG importation and regasification facilities, having bought capacity (but no equity) on a long-term basis at Lake Charles in Louisiana, USA and in Elba Island in Georgia, USA and being involved in the development of an LNG regasification terminal at Brindisi, Italy, which is expected to become operational in 2007.

2.13. BG's interests in the UK are considered in detail later in this document.

2.14. Petroliam Nasional Berhad (Petronas), the National Oil and Gas Company of Malaysia, is a fully integrated petroleum corporation. Currently its business activities range from upstream exploration and production of oil and gas to downstream oil refining; petrochemical manufacturing and marketing; shipping; property development; marketing and distribution of petroleum products; trading; gas processing and liquefaction; gas transmission pipeline operations; and marketing of liquefied natural gas.

2.15. Petronas currently supplies about 16.5 million tonnes per annum (mtpa) of LNG to customers in Japan, Taiwan and Korea, from its 23 mtpa production facility in Sarawak, Malaysia. In 2003 Petronas acquired a 35.5% stake in the Egyptian LNG project from Edison SpA, and also acquired a 50% equity stake in the West Delta Deep Marine concession in Egypt where the gas being produced from the concession is being supplied to the Egyptian LNG project and to the Egyptian market.

2.16. The investment in the Dragon LNG project will give Petronas access to the UK gas market as a new entrant.

Conditions for exemption

2.17. The June 2003 document set out the parts of the Gas Directive that can be exempted by the relevant regulatory authority. In brief, exemption is possible from the need for pre-approval either of tariffs (which by implication includes the pre-approval of the revenue and return of the infrastructure developer) or tariff methodologies. Exemption by the relevant regulatory authority is possible if the development meets five criteria.

2.18. The five criteria relating to an exemption are:

- the investment must enhance competition in gas supply and enhance security of supply;
- the level of risk attached to the pipeline is such that the investment would not take place unless an exemption is granted;
- 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;
- charges are levied on users of that infrastructure; and
- 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.

Exemption criteria applied to the Dragon LNG Ltd request

2.19. Set out below are the arguments that Dragon LNG Ltd put forward in its draft application as to why each of the exemption criteria in respect of its draft exemption application are met.

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

2.20. Dragon LNG Ltd has provided a qualitative analysis of the GB gas market. In this analysis, Dragon LNG Ltd (as suggested by DTI / Ofgem) have analysed three market segments:

- Upstream

  Dragon LNG Ltd explains that BG's current market share is approximately 8%. Detailed figures have been forwarded to Ofgem in a confidential annex, including estimates of BG's market share without its throughput interest in the Dragon LNG terminal.

  Petronas is not active in the UK gas supply market at present. The sale of capacity in the terminal to Petronas would result in a new entrant to the British market, thereby enhancing competition.

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  Dragon LNG Ltd states its view that there is not a single wholesale market. Instead, Dragon LNG Ltd takes the view that wholesale activity can take place in a variety of ways, eg. at the NBP, OCM, OTC or the IPE run futures markets. Dragon LNG Ltd comments that for this reason that it is difficult to provide any meaningful analysis of the wholesale market if this is treated as being distinct from the upstream market.

  Dragon LNG Ltd does, however, state that, in its view, given that traded volumes at the NBP far exceed physical volumes, that this is a liquid and competitive market.

- Downstream

  Dragon LNG Ltd is of the opinion that this market segment includes all sales of gas to domestic users, industrial and commercial customers and power generators (excluding sales made directly to industrial and commercial and power generator customers at the wholesale level).

  Petronas is not active in the downstream market. BG's percentage share of the downstream market – if this includes gas for power generation purposes – is in single figures. The exact figure is detailed in a confidential annex.

  Dragon LNG Ltd's overall view is that competition in the downstream market is strong. To support this view, Dragon LNG quotes BBL's application which stated that the combined downstream HHI was 1359 and that 21 companies were active in this market segment. Attention is also drawn to the fact that in the UK, this market sector is characterised by a high degree of switching.

2.21. In the DTI / Ofgem document, we identified three areas that would help to demonstrate that an infrastructure project did enhance competition in gas supply:

- Requirement to offer initial capacity to the market, ie. an "open season" requirement – Dragon LNG Ltd details the nature of the open season it held with respect to the allocation of capacity rights at the terminal.

  Petroplus had discussions with 28 parties regarding participation in the import terminal project, and this project had also been covered in the trade press. It was through this process that the initial capacity rights of 6bcm and expansion options had been awarded to BG and Petronas.

- Use it or Lose It (UIOLI) arrangements – The Throughput Agreements will be structured in such a way as to enable the secondary trading of capacity between BG and Petronas in the event that either party is not using its full capacity entitlement. In the event that neither BG nor Petronas wishes to use capacity, Dragon LNG Ltd proposes that such capacity would be advertised to the market in an appropriate electronic form, eg. via a website, together with the relevant timetable for the submission of offers and other relevant information.

- Appropriate information gathering powers – Dragon LNG Ltd has agreed to provide Ofgem with facility utilisation data on a monthly basis and also with any other information where this is reasonably required. Dragon LNG Ltd does, however, express its concern that any requirement to publish information to the wider market should not prejudice the commercial positions of its customers, through for example the identification of an individual customer's flows of gas.

2.22. Dragon LNG Ltd explains that the investment will enhance security of supply in Great Britain. To support this view, they claim that:

- the project will help to offset declines in indigenous production;

- the project will provide a new source of gas, i.e. LNG imports; and

- if the project goes ahead, it will be a guaranteed source of additional import capacity which will enable gas supply for the UK that could otherwise be sold into a market with a more attractive regulatory regime, eg. US.

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

2.23. Dragon LNG Ltd argues that the project will not proceed unless the exemption covers the period of the Throughput Agreements and 100% of the capacity, including the expansion options.

2.24. Dragon LNG Ltd argues that in respect of both the initial capacity and the future expansions, the duration of an exemption must be 20 years from the start of each phase (this would match the 20 year Throughput Agreements likely to be put in place in respect of each capacity tranche). A shorter exemption period would endanger the possibility of securing LNG supplies and the necessary financing.

2.25. In particular, Dragon LNG Ltd states that European law precedents support the granting of an exemption for periods in excess of 20 years. Additionally, Dragon LNG Ltd points out the negative impact that a shorter period would have on the terminal's tariff rates and the ability of BG and Petronas to secure long-term LNG supplies. Tariffs would be higher, argues Dragon LNG Ltd, and BG and Petronas would face more difficulty in securing long-term LNG supplies.

2.26. Dragon LNG Ltd asks that the capacity expansion options should be covered by a 20 year exemption (from the time when the additional capacity becomes operational) as this was the basis on which BG and Petronas placed a commercial value on the initial 6bcm of capacity rights. If the additional capacity were not exempted, it would have negative impact on the ability of both companies to achieve the economies of scale in the LNG chain that are essential to ensure competitiveness and profitability.

2.27. The expansion plans, Dragon LNG Ltd points out, do not prevent it from selling capacity to third parties. The only caveat to this is that this does not undermine the expansion options granted to BG and Petronas.

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

2.28. Dragon LNG Ltd explains that the terminal operator will be a separate legal entity from National Grid Transco to whose system the terminal will be connected.

d) Charges are levied on users of that infrastructure

2.29. Dragon LNG Ltd explains that the terminal will operate on the basis of market-based throughput fee charged as a tariff per therm of throughput. The exact details will be set out in the Throughput Agreements. The Throughput

Agreements will also include fixed charges which Throughputters will have to pay irrespective of use.

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

2.30. Dragon LNG Ltd has estimated the proportion of capacity that the terminal will have relative to other LNG terminals in the European Economic Area (EEA). Even if both expansion plans are exercised, the Dragon LNG import terminal will have no more than 6% of the potential LNG regasification capacity in the EEA.

2.31. The connection of the Dragon LNG import terminal will be on the same basis as other new connections to Transco's network.

Ofgem's initial view

2.32. We explained in the June 2003 document that we were prepared to give early guidance to infrastructure developers as to whether developers might expect formal exemption from the requirements of the Directives. We also explained the caveats that came with such guidance. In particular, we noted that in advance of receiving powers to regulate interconnectors and LNG import terminals, Ofgem is not legally in a position formally to exempt certain infrastructure. As and when such powers are available to Ofgem, we would intend formally to consult on exemption requests. Against that background, Ofgem's views as to the application made by Dragon LNG Ltd are as follows.

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

2.33. Ofgem is encouraged that Petroplus conducted an open season in which parties were invited to express their interest in obtaining capacity at the import terminal. Ofgem has indicated on previous occasions its support for such a process.

2.34. Dragon LNG Ltd is proposing to offer UIOLI services. The Throughputters will have also to pay fixed charges irrespective of use of the terminal. It is the view of the Throughputters that this provides a good incentive for them to maximise use of their capacity. However, given that BG and Petronas would have first option on each other's unutilised capacity before it was offered to the rest of the market, Ofgem has yet to be convinced that this would result in unused capacity being made available to the market on a transparent and non-discriminatory basis. Robust UIOLI rules form an important part of the basis on which an exemption is granted and this is an issue that Ofgem will be discussing further with Dragon LNG Ltd.

2.35. With respect to upstream competition, it is clear that the gas sourced by Petronas should enhance competition. Petronas has no current interests in supplying gas to the UK. Hence, it can be seen as a significant new entrant to the UK upstream market.

2.36. Additionally, Ofgem notes that, based on BG's present upstream market share of 8%, and the market share data provided by BG, the addition of the volumes of gas that BG would bring in via Dragon does not create a substantive issue from a market share perspective. An initial view is that it would be difficult to conclude that attributing an initial 3bcm each and the expansion options to Petronas and BG would have a detrimental impact on competition at the upstream level.

2.37. At the wholesale level, Ofgem recognises the fact that gas brought through the terminal will be sold at the NBP, ie. a liquid traded market. Moreover, Ofgem also welcomes Dragon LNG Ltd's comment that the neither BG nor Petronas will impose any resale or destination restrictions on the gas sold, and that this should allow the further trading of the gas.

2.38. As Petronas will be a new entrant to the wholesale market, it would be reasonable to conclude that this would have a subsequent positive impact on competition in the downstream market. BG has forwarded confidential information relating to its own downstream interests. BG has indicated that as it does not supply gas to domestic, commercial and industrial customers, its downstream market share is zero and that this will remain the case even after taking into account the impact of gas flows from the import terminal. This market share estimate, however, does not include gas supplied for power generation.

2.39. Other estimates, however, do attribute some downstream market share to BG as result of its power generation contracts, and Ofgem thinks it reasonable to do so. However, even in this scenario, BG's percentage share of the downstream market is in single figures and this would remain the case - other things being equal - after including future gas flows from the import terminal. As such, Ofgem considers that the Dragon LNG import terminal will not have a negative effect on downstream competition.

2.40. As for security of supply, Ofgem considers that the addition of a new source of gas will be beneficial for security of supply. In addition, the location of the gas should be beneficial for diversity of supply.

2.41. In summary, the above is intended to explain Ofgem's current thinking as to the competition factors relevant to a consideration as to whether this criterion is met. It has been explained that the project seems beneficial for upstream gas competition, security of supply and diversity of supply. We have explained that we consider the project to have no material effect on downstream competition.

2.42. Although an initial view is that this criterion would therefore appear to have been met, Ofgem will clearly have to consider respondents' comments before coming to a definitive view (in particular, with respect to the proposed UIOLI arrangements). However, one way in which any subsequent concerns could be addressed would be through the conditions attached to any exemption, or the circumstances in which any exemption could be withdrawn. This is explained further below.

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

2.43. Ofgem is satisfied with the Dragon LNG Ltd view that the level of risk attached to the project is significant. We agree that the terminal is only one part of the entire gas supply chain.

2.44. Ofgem notes the comments made by Dragon LNG Ltd's financial advisors, Société Générale, regarding the impact of the sustainability of cash flows, particularly the throughput capacity revenues paid by BG and Petronas (as the throughputters) on the financing of the project. These *'reliable'* revenues under long-term agreements with experienced and creditworthy LNG operators would, in Société Générale's view, be a vital consideration for potential lenders, especially when considered within the context of the impact of competing projects.

2.45. Having taken into account the above comments, Ofgem would expect this criterion to be met.

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

2.46. It is clear that the terminal will be fully separate from National Grid Transco. We would therefore expect this criterion to be met.

d) Charges are levied on users of that infrastructure

2.47. Ofgem is content that on the basis that all tariffs will be published, this exemption 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

2.48. Ofgem considers that the connection of the Dragon LNG import terminal to UK system will not be detrimental to the effective functioning of the internal gas market in the UK. Entry capacity to the Transco system will be booked consistent with other entry capacity. Ofgem is not aware of any technical implications of the connection, eg. gas quality, but to the extent that there were, Ofgem would expect these to be resolved by Dragon LNG Ltd and National Grid Transco. As such, we consider that this exemption criterion is likely to be met.

2.49. We have not considered this application in the context of the internal gas market in Europe. We would expect this to be an important consideration for the European Commission.

2.50. Under the new Directive, the European Commission has two months in which it can veto a decision by the relevant authority in a Member State to grant an exemption, or to seek to modify the terms on which the exemption was granted.

Scope of an exemption

2.51. Dragon LNG Ltd has requested that an exemption be granted for the full capacity of the terminal. An initial 6BCM of capacity will be made available in late 2007. Dragon LNG Ltd is has also granted options to BG and Petronas with respect to the additional 6BCM, the timescale for which has yet to be finalised.

Withdrawal of an exemption

2.52. In the initial views paper, DTI and Ofgem explained the grounds for withdrawal of an exemption. These included bankruptcy of the terminal operator and breach of competition law.

2.53. In the final views paper, the DTI and Ofgem expanded upon grounds for the withdrawal of an exemption. These are now envisaged to include:

- breach of exemption criteria
- breach of competition law
- bankruptcy
- mergers / acquisition activity

Summary

2.54. We have explained Ofgem's initial view as to the draft application made by Dragon LNG Ltd. In summary, we consider that all five criteria in the Gas Directive seem likely to be met and, as such, this project could be expected to have an overall positive impact on competition and security and diversity of supply for the UK.

2.55. If that transpires to be the case, Ofgem is of the view that it would be appropriate to grant 20 year exemptions for each of the development phases.

3. Way forward

3.1. Dragon LNG Ltd has requested that Ofgem is able to provide guidance as early as possible. Before being able to do so, Ofgem wishes to seek the views of interested parties. In addition, before we come to a final view, and given the veto powers of the European Commission, DTI and Ofgem will be discussing our proposed view with the European Commission. At this point, we expect to reach a decision as to the application by Dragon LNG Ltd by mid-May.

Appendix 1 – Application Letter from Dragon LNG Ltd

DRAGONLNG

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

Our ref. B0014

London 17 March 2004

Dear Sir

Proposed Dragon LNG import terminal: informal application for exemption from Regulated Third Party Access

Dragon LNG Limited ("Dragon") is developing an LNG import facility in Milford Haven, Wales. Dragon seeks comfort that the proposed LNG import facility will be exempted from the regulated tariff and third party access provisions of Directive 2003/55/EC. The exemption requested is required if the project is to proceed as scheduled.

It is Dragon's understanding that Ofgem will only formally acquire powers to grant exemptions in accordance with Article 22 of Directive 2003/55/EC once the Directive is transposed into UK law. However, given the scale of advance commitments required for the facility and the remaining parts of the LNG chain, Dragon will need assurances on as binding a basis as possible that the Facility will be exempted on the terms requested when the legislation is in place. A high level of comfort is therefore being sought from both the UK regulatory authorities and the European Commission. In pursuit of such comfort Dragon has prepared an informal request for an exemption in accordance with Article 22 of Directive 2003/55/EC. To enable the project to proceed as envisaged Dragon requests that the procedure for giving such comfort be expedited.

Dragon will be grateful for Ofgem's favourable consideration of its request and remains at your disposal to clarify further any issues you might raise.

Yours faithfully,

P. Q.J. van Poecke
Dragon LNG Ltd

cc Ms Sue Harrison – Department of Trade and Industry

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