

Dragon LNG Ltd: Draft application for an exemption for the Milford Haven LNG import terminal

Final views

June 2004

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1. Introduction

- 1.1. In February 2004, Ofgem issued an initial views paper¹ on a draft application that had been received from Dragon LNG Ltd's proposed 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 Dragon LNG Ltd dated 23 June 2004 (see appendix 1).
- 1.2. The Dragon LNG Ltd 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 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. Project developers have requested early informal non-binding guidance as to whether they could expect

¹ 'Dragon LNG Ltd , Draft application for an exemption from the Regulated Third Party Access provisions of the Gas Directive, Initial Views', Ofgem, April 2004

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

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, Amrik Bal on 020 7901 7074 or Jo Witters on 020 7901 7159.

2. Discussion of the request

- 2.1. Ofgem's initial views document set out the arguments presented by Dragon LNG Ltd 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 Dragon LNG Ltd and the European Commission respectively. The full list of documents supplied by Dragon LNG Ltd 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 Dragon LNG Ltd's application outright. Another respondent offered qualified support for some form of exemption but commented that, in its view, there should be a requirement for a further open season in relation to the second phase of the facility. This respondent also called for robust Use-It-Or-Lose-It-Services (UIOLI). The final respondent concluded that while it supported the exemption application in principle, it too questioned the UIOLI arrangements that Dragon LNG Ltd had proposed. Furthermore, this final respondent called for a review of the exemption mid-way through its proposed duration to take into account possible future changes in the GB gas market.

Discussion of the exemption criteria

- 2.4. Views of respondents are summarised below. The views of Ofgem are contained in the letter to Dragon LNG Ltd 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 Dragon LNG Ltd's proposal in a number of different market segments.
- 2.6. With respect to upstream competition, it was 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.
- 2.7. Additionally, Ofgem noted 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 did not create a substantive issue from a market share perspective. An initial view was that it would be difficult to conclude that attributing an initial 3bcm each and the expansion options⁴ to Petronas and BG would have a detrimental impact on competition at the upstream level.
- 2.8. At the wholesale level, Ofgem recognised the fact that gas brought through the terminal would be sold at the NBP, ie. a liquid traded market. Moreover, Ofgem also welcomed Dragon LNG Ltd's comment that the neither BG nor Petronas would impose any resale or destination restrictions on the gas sold, and that this should allow the further trading of the gas.
- 2.9. As Petronas would be a new entrant to the wholesale market, it would be reasonable to conclude that this would have a subsequent positive impact on

⁴ Details of the proposed future expansion plans can be found in Ofgem's initial views document regarding Dragon LNG Ltd's request for informal guidance.

competition in the downstream market. BG forwarded confidential information relating to its own downstream interests. BG 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.

- 2.10. Other estimates, however, did attribute some downstream market share to BG as result of its power generation contracts, and Ofgem thought it reasonable to do so. However, even in this scenario, BG's percentage share of the downstream market was in single figures and this remained the case - other things being equal - after including future gas flows from the import terminal. As such, Ofgem considered that the Dragon LNG import terminal would not have a negative effect on downstream competition.
- 2.11. As for security of supply, Ofgem considered that the addition of a new source of gas should be beneficial for security of supply. In addition, the location of the gas should be beneficial for diversity of supply.
- 2.12. In summary, the above was intended to explain Ofgem's 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.
- 2.13. Additionally, Ofgem was 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 previously indicated its support for such a process.
- 2.14. Dragon LNG Ltd is proposing to offer UIOLI services. The throughputters will also have 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. Ofgem was concerned that a mechanism which allowed secondary trading of capacity between BG and Petronas only could prevent unused capacity being released to the market in a transparent and non-discriminatory way. As robust UIOLI rules form an important part of the basis on which an exemption is granted Ofgem committed to further discussions with Dragon LNG Ltd on UIOLI.

Respondents' views

- 2.15. None of the respondents commented specifically on whether this project could be expected to enhance competition, although none disagreed with Ofgem's initial view that we would expect this particular criterion to have been met.
- 2.16. All three respondents, however, did agree that the terminal could be expected to have a positive impact in relation to the security and diversity of supply.
- 2.17. Two respondents commented on the issue of the proposed UIOLI services to be offered. One of these respondents stated that it had yet to be convinced that Dragon LNG Ltd's UIOLI proposals would result in all capacity being made available to the market on transparent and non-discriminatory terms.
- 2.18. The other respondent who commented on the nature of the UIOLI services called them a 'reasonable first step' but asked that Ofgem considers the issues of tanker size, gas quality, and notice periods when looking at UIOLI services. Moreover, this respondent continued to note that it was important that the facility operator is required to facilitate secondary trading as a precursor to UIOLI.

Ofgem's Final Views

- 2.19. Ofgem remains of the view that in terms of upstream and wholesale market considerations, as a new entrant to both market sectors, the presence of Petronas could be expected to enhance competition in both.
- 2.20. As for the downstream market, Petronas has no existing interests and this situation is not expected to change. However, it should be noted that Petronas' involvement as a new entrant in the upstream and wholesale markets can be expected to be good for downstream competition.
- 2.21. BG's share of the upstream market is 8% and the addition of gas volumes from the import terminal are not expected to change this figure to the extent that it would raise any competition concerns. This remains the case even after having taken into account the expansion options available to BG (and Petronas).
- 2.22. At the wholesale level, Ofgem recognises that gas brought through the terminal will be sold at the NBP, ie. a liquid traded market. Moreover, Ofgem continues

to welcome Dragon LNG Ltd's advice 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.

- 2.23. In terms of the downstream market, BG's percentage share – even taking into account BG's contracts to supply power generators - 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 in terms of a change in BG's position.
- 2.24. Therefore, 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.
- 2.25. 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.
- 2.26. Ofgem has had further discussions with Dragon as to the nature of the UIOLI services proposed by Dragon. Ofgem remains committed to the requirement of robust UIOLI services so that unused capacity is made available to the market, and to ensure capacity is not hoarded. Ofgem has been reassured by Dragon that the Secondary Trading Capacity mechanism described in Annex 5 of the exemption request would not prevent unused capacity being made available to the market. The throughputters will retain their capacity rights and ability to trade their capacity until the point at which they are obliged to notify Dragon that they do not expect to use any of their capacity entitlement. In the event there is capacity available which the throughputters do not intend to use, Dragon will advertise this capacity to the market in a transparent and non-discriminatory way.
- 2.27. Such an approach is consistent with Ofgem's desire not to regulate how primary capacity holders use their capacity, but that in the event such capacity is not used, it cannot be hoarded but is made available to the market. The publication of information by Dragon LNG Ltd regarding the capacity utilisation rates of the primary rights holders and the subsequent volumes that are made available to third parties is a vital component of this anti-hoarding mechanism. Ofgem's

general approach is also consistent with the UIOLI arrangements for NTS entry capacity which allows capacity holders to trade such capacity.

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

- 2.28. In our initial views document, Ofgem commented that it was satisfied with the Dragon LNG Ltd view that the level of risk attached to the project is significant. Ofgem noted 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.
- 2.29. 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.
- 2.30. Having taken into account the above comments, Ofgem expected this criterion to be met.

Respondents' views

- 2.31. Only one respondent specifically commented on this issue and stated that it understood the basis on which the application had been made for 20 years for each phase of the terminal. This respondent, however, also commented that any expansion should be the subject of a separate open season.

Ofgem's final views

- 2.32. 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.

2.33. Therefore, in that context, on the basis of the analysis provided by Dragon LNG Ltd and its financial advisors, 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 import terminal merits 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

2.34. Ofgem explained that it was clear that the terminal would be fully separate from National Grid Transco, owners of the high pressure transmission system. On that basis, we expected this criterion to be satisfied.

Respondents' views

2.35. One respondent explicitly agreed with Ofgem's initial view. The other two respondents made no comment.

Ofgem's final view

2.36. As noted above, Ofgem considers that this criterion is likely to be met.

d) Charges are levied on users of that infrastructure

Ofgem's initial view

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

Respondent's views

2.38. Two respondents commented on this point. One thought that it this criterion could only be met on the basis that the tariffs were published and that this view extended to the prices in the Throughput Agreements.

- 2.39. The other respondent sought clarification as to the way in which this information would be published as part of any Ofgem decision.

Ofgem's final view

- 2.40. 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. Dragon LNG Ltd has agreed to such publication. The way in which this information would be published would clearly have to be decided upon prior to any formal decision to exempt Dragon LNG Ltd's terminal.
- 2.41. 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

- 2.42. Ofgem considered that the connection of the import 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 Dragon LNG Ltd and National Grid Transco. As such, we considered that this exemption criterion is likely to be met.

Respondents' views

- 2.43. One respondent commented that while the terminal's share of the European LNG regasification market would be 6%, this figure would be higher when looking at the GB market. This respondent requested that Ofgem takes this into account when considering the request for an exemption.
- 2.44. The other two respondents did not comment on this issue.

Ofgem's final view

- 2.45. Ofgem notes that the connection of the terminal will be on terms consistent with arrangements elsewhere on Transco's system. Additionally, the import terminal will increase the supply of gas to Europe in general, and UK in particular, and is not the only such project planned for UK.
- 2.46. Importantly, Dragon LNG Ltd says that the contractual arrangements being negotiated by BG and Petronas 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.
- 2.47. It is true that the import terminal would have a higher share of the GB LNG regasification segment than it does of the European LNG regasification segment (if such regasification segments were found to constitute relevant markets). However, Ofgem believes that it is more appropriate to consider the terminal within the context of upstream supplies to GB rather than a LNG regasification market per se. In that instance, the market share of Dragon LNG Ltd's import terminal would not appear to raise any concerns.
- 2.48. Ofgem has therefore concluded that the project is likely to meet this particular criterion.

Scope of an exemption

- 2.49. In its initial views paper, Ofgem noted that Dragon LNG Ltd has requested that an exemption of twenty years for each of the two phases of the project. Ofgem's initial view was that it would be appropriate to grant the exemption as requested, with any capacity not taken by BG and Petronas offered back to the market.

Respondents' views

- 2.50. None of the respondents disagreed with Ofgem's initial view that it would be appropriate to grant the exemption for the period requested.

- 2.51. One respondent did indicate that it thought it necessary that Ofgem conducts a formal review of the exemption after a fixed period of time, eg. ten years, to take into account changes in the GB gas market.
- 2.52. Another respondent, while it suggested that a second open season should be held in relation to any expansion of the facility, nonetheless commented that once granted, an exemption should be definitive.

Ofgem's final view

- 2.53. Ofgem remains of the view that it would be appropriate to grant an exemption for the full duration of the throughput contracts for each development phase underlying the investment. 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.
- 2.54. The conditions for modification or withdrawal of an exemption are:
- ◆ A material breach of exemption criteria by either the terminal operating company or the throughputters;
 - ◆ A proven breach of EU or UK competition law by either the terminal operating company or the throughputters;
 - ◆ Insolvency of the terminal operating company
 - ◆ Insolvency of one or more of the throughputters where this is likely to lead to capacity in the terminal remaining unused; and
 - ◆ Merger / acquisition activity of the sponsors or the terminal operating company that would have a material impact in relation to the terminal exemption.
- 2.55. 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.

- 2.56. A decision to modify or withdraw an exemption on any grounds would not be taken without prior consultation with all interested parties, particularly where such consultation could result in remedies being implemented which might avoid the need to withdraw or modify the exemption

Conclusions

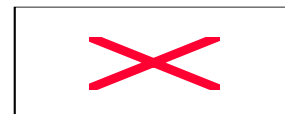
- 2.57. On the basis of the application made by Dragon LNG Ltd and the supporting information provided by Dragon LNG Ltd, and the views of respondents, Ofgem currently envisages granting an exemption as permitted under Article 22 of the Gas Directive. The exemption would be from Articles 18, 25(2) and 25(4) of the Directive.
- 2.58. An exemption from Article 19 is not necessary on the assumption that the storage part of the proposed import terminal 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
- 2.59. Ofgem proposes that the exemption will be for the entire capacity of the underlying throughput contracts relating to each development phase of the project.

3. Way forward

- 3.1. Ofgem sent the letter in appendix 1 to Dragon LNG Ltd on 23 June 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 to consult formally on the Dragon LNG Ltd proposal.

Appendix 1

Mr P Q.J van Poeke
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Bringing choice and value

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23 June 2004

Dear Mr van Poeke

Dragon LNG Ltd LNG Import Terminal in Milford Haven, South Wales: Informal application for exemption from regulated third party access

Thank you for your letter, of 17 March 2004. You asked for Ofgem's views in relation to your draft application for exemption from certain requirements of the Gas Directive with respect to the proposed 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 views⁵ 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 February 2004. 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 Dragon LNG Ltd application, which will be published shortly.

⁵ This final views document resulted from a consultation document issued in June 2003
Dragon LNG Ltd: Draft exemption application for the Milford Haven LNG import terminal: Final Views
Office of Gas and Electricity Markets 15 June 2004

Dragon LNG Ltd has 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 Dragon LNG Ltd 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 Dragon LNG Ltd.

You have also included a quantitative analysis of the effect on competition of the project. In line with the structure suggested by Ofgem, you have considered the competitive effect on upstream, wholesale and downstream competition. You explain that Petronas will be a new entrant to the British market. Additionally, your application states that:

- ◆ at the upstream level BG's market share stands at 8% and that from a competition perspective, the addition of gas volumes from the import terminal, including the expansion options, will have no appreciable impact.
- ◆ at the wholesale level, neither BG nor Petronas will impose any destination or resale clauses and that the gas will be sold into the liquid NBP market; and
- ◆ BG's percentage share of the downstream market, even on the most generous assumptions, remains in single figures.

The current views of Ofgem are given below.

Petronas

With respect to upstream competition, Petronas 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, Petronas appears as a significant new entrant through its acquisition of capacity in the proposed import terminal which will be reselling gas into the wholesale market.

As for downstream competition, it is clear that Petronas 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 Petronas, 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.

We have considered the impact of the terminal on the wholesale market. It is Ofgem's view that Petronas as a new entrant per se could be expected to have a beneficial impact. Moreover, Ofgem remains of the view that, in general, given the fact that gas from the terminal will not be subject to any resale or destination clauses and will be sold into a liquid traded market can be expected to have a beneficial impact.

BG

We have considered BG's position upstream. In our initial views document, we explained that BG's current market share of 8% does not raise any competition concerns. This remains the case when taking into account gas volumes from the import terminal, including the expansion options. In this context, we would conclude that the import terminal should increase upstream competition on the basis of the information available to us.

We disagree with BG's comment that its sales to power generators at the NBP should not be included in its downstream market share figures, as we believe it is reasonable to count these supplies as part of the downstream market. However, even taking into account those contracts, BG's market share as result of its interest in the import terminal does not raise any competition concerns. On that basis, the effect on downstream market shares is neutral.

In the initial views consultation, we considered the issue of the availability of robust UIOLI services. Although we noted that Dragon LNG Ltd had proposed a form of such services, we were concerned that the description of the Secondary Trading mechanism in Annex 5 would prevent unused capacity being made available to the market in a transparent and non-discriminatory way. Ofgem does not desire to regulate the way in which the throughputters exercise their primary capacity rights. However Ofgem is committed to preventing hoarding of capacity. Ofgem has now been reassured by Dragon that the Secondary Trading Capacity mechanism described in Annex 5 would not prevent unused capacity being made available to the market. Ofgem is content that Throughputters will retain their capacity rights and the right to trade their capacity until the point at which they are obliged to notify Dragon that they do not expect to use any of their capacity entitlement. Ofgem is now satisfied that any unused capacity would then be advertised to the market in a transparent and non-discriminatory way, as outlined in the Use it or Lose it Mechanism described in Annex 5.

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 Petroplus to undertake an open season is a positive factor in our consideration of Dragon LNG Ltd's draft application.

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

The second part of this criterion relates to security of supply. Ofgem considers that the addition of a new source of gas (i.e. Petronas) 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 Dragon LNG Ltd 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 BG and Petronas 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 a twenty year exemption is required for 100% of the capacity for both phases.

We are content with the Dragon LNG Ltd 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 Dragon LNG Ltd, and its financial advisors, Société Générale, 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 Dragon LNG Ltd, Petroplus, BG and Petronas 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

Dragon LNG Ltd has agreed to the publication of tariffs for both primary capacity used by BG and Petronas and for capacity to be made available to third parties. A suitable manner for the publication of this information would have to be decided upon prior to any formal decision to exempt.

On the basis that this happened, 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 import terminal 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, Ofgem believes that existing continental European gas supplies will not be required for the UK, thereby increasing

supply in other EU Member States. You also explain that the contractual arrangements being negotiated by BG and Petronas 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 current grounds on which an exemption, once granted, could be expected to be modified or withdrawn. These are

- ◆ A material breach of exemption criteria by either the terminal operating company or the throughputters;
- ◆ A proven breach of EU or UK competition law by either the terminal operating company or the throughputters;
- ◆ Insolvency of the terminal operating company
- ◆ Insolvency of one or more of the throughputters where this is likely to lead to capacity in the terminal remaining unused; and
- ◆ 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.

A decision to modify or withdraw an exemption on any grounds would not be taken without prior consultation with all interested parties, particularly where such consultation could result in remedies being implemented which might avoid the need to withdraw or modify the exemption

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.

Summary

We have explained above Ofgem's current view as to the Dragon LNG Ltd draft application for exemption from certain aspects of the Gas Directive. We have concluded that the application 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 throughput contracts that will underpin

the construction of the Dragon terminal. We would currently expect to grant exemption for the full duration of the throughput contracts relating to each development phase of the project.

Yours sincerely

A handwritten signature in black ink that reads "Kyran P. Hanks". The signature is written in a cursive style and is underlined with a long, horizontal stroke.

Kyran P Hanks
Director, Wholesale Markets

APPENDIX 1

Conditions relevant to Ofgem's view

This letter is limited by the fact that Ofgem currently has no legal vires 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 Dragon LNG Ltd. This letter is not intended 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 relevant market conditions which are in existence at the time of your formal application for exemption are 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 February 2004 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.

Appendix 3 : Documents submitted to the European Commission

1. Public version of Dragon LNG Ltd's draft application (17 March 2004)
2. Confidential version of Dragon LNG Ltd's draft application (17 March 2004)
3. Letter from Société Générale on the financing considerations (6 Feb 2004)
4. Ofgem's final views – letter to European Commission (21 June 2004)
5. Ofgem's final views – letter to Dragon LNG Ltd (23 June 2004)
6. Ofgem's *Final Views* document (June 2004)