

**Application by Grain LNG Ltd under section  
19C of the Gas Act 1986 for an exemption  
from section 19D of the Gas Act 1986**

**Ofgem Initial views**

October 2004

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## Summary

The new Gas and Electricity Directives<sup>1</sup> introduce a regulated third party access (RTPA) regime for interconnectors and Liquefied Natural Gas (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 such an exemption being granted.

On 12 August 2004, Grain LNG Ltd (GLNG), a subsidiary of National Grid Transco plc (NGT), wrote to Ofgem requesting an exemption under Section 19C(2) of the Gas Act from the application of Section 19D of the Gas Act to all the proposed capacity of its LNG importation facility on the Isle of Grain.

In its application, GLNG explains that its application demonstrates that the Isle of Grain LNG import facility satisfies the criteria set out in Section 19C of the Gas Act for an exemption from the RTPA obligations of Section 19D, as well as the complementary tests set by Ofgem and the DTI. GLNG suggests that the granting of an exemption should not give rise to any concern for the regulatory authorities and will enable the GLNG facility to deliver significant benefits to the UK and EU in relation to security of supply and competition in gas supply.

In summary, Ofgem's preliminary view is that all the criteria are 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. Therefore, Ofgem's initial view is that it would be appropriate to grant exemption.

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<sup>1</sup> Directive 2003/55/EC of the European Parliament and of the Council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC; and Directive 2003/54/EC of the European Parliament and of the Council concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC.

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# 1. Introduction

## *Background*

### **The Gas and Electricity Directives**

- 1.1. The new Gas and Electricity Directives introduce an RTPA regime for interconnectors and LNG import terminals. The Directives allow exemption from RTPA by the relevant regulatory authorities, subject to veto by the European Commission. With respect to LNG import terminals, the new EU Gas Directive was transposed into GB law with the coming into force of the Gas (Third Party Access) Regulations 2004 on 26 August 2004. Ofgem therefore now has formal powers to grant exemption from the RTPA requirements for LNG import terminals, as set out in sections 19C and 19D of the Gas Act 1986.
- 1.2. The Directives set down criteria that have to be met in order to justify such an exemption being granted. The criteria contained in 19C(7) of the Gas Act relating to an exemption for an LNG import facility are:
  - (a) the facility or (as the case may be) the significant increase in its capacity will promote security of supply;
  - (b) the level of risk is such that the investment to construct the facility or (as the case may be) to modify the facility to provide for a significant increase in its capacity would not be or would not have been made without the exemption;
  - (c) the facility is or is to be owned by a person other than the gas transporter who operates or will operate the pipeline system connected or to be connected to the facility;
  - (d) charges will be levied on users of the facility or (as the case may) the increase in its capacity;

- (e) the exemption will not be detrimental to competition, the operation of an economically efficient gas market or the efficient functioning of the pipeline system connected or to be connected to the facility; and
- (f) the Commission of the European Communities is or will be content with the exemption.

### **DTI/Ofgem exemption policy**

1.3. In June 2003, the Department of Trade and Industry (DTI) and Ofgem issued a joint consultation document concerning new regulations to apply to LNG facilities and interconnectors.<sup>2</sup> This document set out our initial views regarding the regulatory regime for interconnectors and LNG facilities. In addition to a quantitative competition analysis, DTI/Ofgem identified three areas that would be minimum requirements for an exempt regime:

- ◆ a requirement to initially offer capacity to market, i.e. an “open season” requirement;
- ◆ effective secondary trading and anti-hoarding mechanisms, i.e. Use It or Lose It (UIOLI) arrangements; and
- ◆ the provision of information.

1.4. In November 2003, the DTI and Ofgem issued final views in relation to the new Directives and the resulting regulatory regime.<sup>3</sup> By and large, the final views document confirmed, and clarified, the position set out in the initial views document. DTI and Ofgem expanded upon grounds for withdrawal of an exemption:

- ◆ breach of exemption criteria;
- ◆ breach of competition law;

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<sup>2</sup> 'LNG facilities and interconnectors, EU legislation and regulatory regime, DTI/Ofgem initial views', DTI/Ofgem, June 2003.

<sup>3</sup> 'LNG facilities and interconnectors, EU legislation and regulatory regime, DTI/Ofgem final views', DTI/Ofgem, November 2003.

- ◆ bankruptcy; or
- ◆ mergers / acquisition activity.

- 1.5. At the time, there were several potential projects that were moving to financial close prior to the Directives becoming transposed into GB law. Project developers requested early guidance as to whether they could expect their particular project to be exempt from RTPA. Ofgem said that while it would be prepared to give such guidance, any guidance 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. Ofgem indicated that while we would aim to ensure, as far as possible, that any potential guidance that is issued gave 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. Ofgem received draft applications for exemption in respect of three projects. In each case, Ofgem consulted upon, and issued regulatory guidance to, each project. The first application was from Gastransport Services (GTS) for the proposed Balgzand Bacton pipeline project (BBL).<sup>4</sup> The second application was received from Qatar Petroleum and ExxonMobil for the proposed South Hook LNG import terminal at Milford Haven in Wales.<sup>5</sup> The third application was received from Dragon LNG Ltd for the proposed LNG import terminal, also at Milford Haven.<sup>6</sup>
- 1.7. In each case, Ofgem expressed the view that the application for exemption would be likely to meet each of the exemption criteria set out in the relevant EU legislation. In these documents, Ofgem stated that once legislative authority was granted to Ofgem in respect of the licensing and exemption of

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<sup>4</sup> 'Gastransport Services, Draft application for an exemption for the Balgzand Bacton Pipeline project (BBL), Final views', Ofgem, December 2003.

<sup>5</sup> 'Qatar Petroleum and ExxonMobil, Draft Gas Directive Exemption Application for an LNG Terminal at Milford Haven, Final views', Ofgem, February 2004.

<sup>6</sup> 'Dragon LNG Ltd, Draft application for an exemption for the Milford Haven LNG import terminal, Final views', Ofgem, June 2004.

interconnectors and LNG facilities, Ofgem would expect to undertake a formal consultation process in respect of formal applications it receives for exemption.

- 1.8. In each case, Ofgem's views were submitted to the European Commission who indicated general support for Ofgem's position.
- 1.9. GLNG did not submit an application for written regulatory guidance. Its decision to invest was taken ahead of the DTI/Ofgem policy on the issuing of written regulatory guidance. GLNG did however receive verbal guidance from the DTI and Ofgem that it could expect to be exempt as and when formal powers became available.

### **Formal application by Grain LNG Ltd**

- 1.10. On 12 August 2004, GLNG, a subsidiary of NGT, wrote to Ofgem formally requesting an exemption under Section 19C(2) of the Gas Act from the application of Section 19D of the Gas Act to all the proposed capacity of its LNG importation facility on the Isle of Grain. The public version of GLNG's application for exemption can be found on the Ofgem website.<sup>7</sup>

### ***Views invited***

- 1.11. This document presents Ofgem's initial views on GLNG's formal exemption application. Ofgem would welcome views on the initial views contained in this document and on the draft exemption order contained in Appendix 1 to be received by close of business 1 November 2004. All responses will normally be published on Ofgem's website and held in the Research and Information Centre. However, if respondents do not wish their response to be made public then they should clearly mark their response as confidential. Ofgem prefers to receive responses in an electronic form so they can be placed easily on the Ofgem website.
- 1.12. Responses should be addressed to:

Steve Smith  
Managing Director, Markets  
Office of Gas and Electricity Markets  
9 Millbank  
London  
SW1P 3GE

- 1.13. Electronic responses should be sent to [adam.higginson@ofgem.gov.uk](mailto:adam.higginson@ofgem.gov.uk)
- 1.14. If you wish to discuss any aspect of this paper, Adam Higginson (telephone 020 7901 7432) would be pleased to help.

### ***Way forward***

- 1.15. Ofgem will carefully consider responses received to this formal consultation in making a decision on whether to grant an exemption to GLNG from the application of Section 19D of the Gas Act to its LNG importation facility on the Isle of Grain. As with the other applications, Ofgem's decision will include a conclusions document that we would expect to issue in November 2004.
- 1.16. If Ofgem consider the exemption criteria have been met, and before an exemption can actually be granted, the European Commission will make a decision as to whether to veto Ofgem's decision to grant an exemption. 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 request that the regulatory authority amend its decision.<sup>8</sup>

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<sup>7</sup> [www.ofgem.gov.uk](http://www.ofgem.gov.uk), under "Europe" area of work.

<sup>8</sup> This two month period may be extended by one additional month where additional information is sought by the Commission.



## 2. Grain LNG Ltd's exemption application

- 2.1. This chapter provides details of the Isle of Grain LNG import terminal project and GLNG's application for exemption. It additionally provides a summary of the arguments that GLNG puts forward in its application as to why each of the exemption criteria contained in 19C(7) of the Gas Act relating to an exemption for an LNG import facility are met.

### ***Isle of Grain LNG import terminal project details***

- 2.2. NGT presently owns the LNG storage facility at the Isle of Grain through GLNG, a subsidiary separate from Transco (the regulated monopoly owner and operator of the UK's National Transmission System (NTS)). However, this facility is presently operated as a storage facility by Transco under a lease back arrangement from GLNG. As such, it provides storage services to gas shippers using the NTS as well as providing transmission support and system reserve services to Transco.
- 2.3. GLNG is in the process of converting the facility to become an LNG importation and regasification terminal.<sup>9</sup> GLNG intends to build, own and operate the terminal, although the scheduling of gas deliveries to and from the facility will be under the control of holders of capacity rights at the facility. GLNG will dispose of 100 per cent of the facility's capacity to shippers for the purposes of importing LNG.
- 2.4. In July 2003, Ofgem published a decision document<sup>10</sup> which explained Ofgem's approval to the transfer of the Isle of Grain facility out of Transco.
- 2.5. The project has the potential to provide import capacity up to 14.5 billion cubic meters (bcm) per year of LNG, although to achieve this requires

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<sup>9</sup> The leaseback arrangement to Transco and the provision of storage services from the facility will cease upon commissioning of the Isle of Grain terminal as an importation facility whereupon GLNG will become both the owner and operator.

<sup>10</sup> 'National Grid Transco's proposal to transfer its Liquefied Natural Gas facility at Isle of Grain to a separate NGT group company', A decision document, Ofgem, May 2003.

significant investment in infrastructure in the facility. GLNG explains that it intends to build the facility in at least two phases. The reason for doing so is that a phased development would make it possible to achieve part utilisation (4.5bcm) of the facility's proposed capacity in time to meet what GLNG see as a predicted supply deficit by early 2005. Construction activity on the first phase commenced in early 2003. Conversion and commissioning of the Isle of Grain facility to an LNG importation terminal, capable of at least providing the initial capacity will not be completed until early 2005. It is expected that the second phase of expansion capacity (10bcm) could be made available for the winter of 2007/8.

- 2.6. Following an open season in which interested parties were invited to express an interest in the first phase capacity of 4.5bcm per year, BP and Sonatrach have jointly purchased this volume of capacity for a period of 20 years. The second phase of expansion capacity has not yet been purchased although the open-season process has commenced.
- 2.7. GLNG has requested an exemption from the application of Section 19D of the Gas Act to all of the proposed capacity (14.5bcm) of its LNG importation facility on the Isle of Grain. The exemption requested applies to:
  - ◆ the initial capacity of 4.5bcm for a duration of 20 years from 2005; and
  - ◆ the expansion capacity of 10bcm for a duration up to 25 years from 2007/08 at the earliest, dependent upon market requirements.
- 2.8. Irrespective of whether the second phase expansion actually takes place, GLNG requests that the exemption in respect of the initial capacity (4.5bcm for 20 years) is granted.

## ***Exemption criteria applied to the Grain LNG Ltd request***

2.9. Set out below are the arguments that GLNG put forward in its application as to why each of the exemption criteria contained in 19C(7) of the Gas Act relating to an exemption for an LNG import facility are met.

### **(a) the facility or (as the case may be) the significant increase in its capacity will promote security of supply**

2.10. GLNG suggests that the investment will enhance security of supply. To support this view, it says that security of supply will be enhanced by:

- ◆ the introduction of a new non-indigenous source of supply to the UK at a time when indigenous supplies through existing UK entry points are declining;
- ◆ the conversion from a five day per year duration storage facility to one which can operate at baseload with upward and downward flexibility;
- ◆ the capability of the terminal to accept a variety of new supply sources thereby increasing supply diversity; and
- ◆ the potential for LNG imported into the UK at Isle of Grain to flow to other European markets via interconnectors providing an enhancement to European security and diversity of supply.

2.11. In summary, GLNG considers that the development of the GLNG importation terminal will significantly enhance the security of gas supply in both the UK and mainland Europe from 2005 onwards.

### **(b) the level of risk is such that the investment to construct the facility or (as the case may be) to modify the facility to provide for a significant increase in its capacity would not be or would not have been made without the exemption**

- 2.12. GLNG suggests the definition of new infrastructure projects in the Gas Directive specifically enables projects that have commenced construction, but are not yet completed, to be eligible to apply for an exemption. GLNG considers that the assessment as to whether this test is met or not needs to be applied at the point the investment decision was taken and not at the time the exemption application is submitted. The main investment decision relating to the conversion phase of the project was made by the NGT Board in May 2003. The main investment decision in relation to the expansion phase of the project has yet to be made.
- 2.13. GLNG explains that the import terminal is a major, capital intensive project requiring significant investment. GLNG suggests that it is taking significant counterparty,<sup>11</sup> development, construction and operational risks, as the project is not underwritten by public investment and has no guaranteed rate of return or method of recovering income permitted by the national regulator.
- 2.14. GLNG quotes the EC Interpretive note<sup>12</sup> and its identification of a risky investment as one where at least “the investment concerned is a sunk cost in that the asset concerned cannot be recovered and re-used for another purpose other than its original one”. GLNG suggests that the facility could be converted back to a storage facility at a cost but all the investment would be sunk because the terminal already exists as a storage facility.
- 2.15. GLNG explains that the initial capacity of the project is part financed by a £30m loan from the European Investment Bank. GLNG states that the loan is conditional on all necessary consents or approvals from relevant government or public bodies being obtained at the date of commencement of commercial operations.
- 2.16. GLNG suggests that given the cost and lead-time in building upstream facilities (production, liquefaction and shipping), the least risk approach is to

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<sup>11</sup> Costs are underwritten by the parent company, NGT.

<sup>12</sup> *Note of DG Energy & Transport on Directives 2003/54-55 and Regulation 1228/03 in the Electricity and Gas Internal Market: Exemptions from Certain Provisions of the Third Party Access Regime*, 30 January 2004.

put in place long-term contracts with shippers for capacity at the Isle of Grain import terminal. GLNG suggests that without an exemption, long term access cannot be guaranteed. GLNG considers that obtaining an exemption will ensure the continuation in effect of the long term contracts currently in place with BP and Sonatrach which are, it says, essential to underpin the investment.

- 2.17. GLNG suggests that without an exemption, the income assurances required to make the project viable would not be sufficient when taking into account the significant risks associated with the project and NGT's view of the risk-reward balance. The project has a long pay back period and GLNG suggests that the absence of an exemption, or an exemption of shorter duration than that requested, would lead to insufficient returns. GLNG suggests that a lower tariff, or tariff subject to regulatory uncertainty, would be insufficient to ensure that the GLNG importation terminal project remains within the acceptable risk profile for its investors. GLNG suggests that NGT is investing in the initial phase of the project on the basis that it would receive higher rates of return than the LNG storage facility it replaces to cover these additional risks.
- 2.18. GLNG suggests that the application of an RTPA regime at GLNG would lead to cessation of investment by NGT (and potentially importing shippers) because the prospect of reduced tariffs would lead to an untenable payback period and rate of return given the level of risk being taken for the initial capacity and the significantly greater uncertainty of investment not being fully recovered for expansion capacity.
- 2.19. In summary, GLNG explains that the construction work to convert the facility, allowing the release to the market of the initial importation capacity in the winter of 2004/5, would not have commenced without the assumption of an exemption. In addition, GLNG explains that an exemption is essential to ensure the Isle of Grain importation project proceeds.

**(c) the facility is or is to be owned by a person other than the gas transporter who operates or will operate the pipeline system connected or to be connected to the facility**

- 2.20. GLNG explains that the infrastructure owner and, upon successful commissioning as an LNG importation terminal, operator, is GLNG which is a wholly owned subsidiary of Lattice Group plc, a subsidiary of NGT. GLNG explains that the system operator of the system in which this infrastructure is to be built is Transco plc, a wholly owned subsidiary of Transco Holdings plc. Transco Holdings plc and Grain LNG Ltd are separate, independent subsidiaries of Lattice Group plc.
- 2.21. GLNG suggests that the separation of GLNG and Transco activities are further reinforced by licence conditions and obligations contained in the Gas Act 1986 requiring Transco to ensure that no unfair commercial advantage is conferred on, in this case, GLNG. In addition, GLNG suggests that the separation of GLNG and Transco activities are further reinforced by the relevant codes of conduct which are provided by GLNG to any NGT employee working on the Grain LNG project to remind them of the business separation requirements.

**(d) charges will be levied on users of the facility or (as the case may be) the increase in its capacity**

- 2.22. GLNG explains that its capital investment and ongoing costs are to be recovered through the sale of long term importation capacity rights. Importation shippers will pay an annual charge for the use of GLNG capacity. Therefore GLNG states that no part of the costs for the GLNG project will be underwritten through regulated transmission charges. All costs will need to be covered by the receipt of revenues arising solely from the charges levied on the users of the facility.

**(e) the exemption will not be detrimental to competition, the operation of an economically efficient gas market or the efficient functioning of the pipeline system connected or to be connected to the facility**

### **Competition issues**

#### *Competition assessment*

- 2.23. In accordance with DTI/Ofgem’s guidance, GLNG commissioned its own independent assessment by Frontier Economics of the impact on competition of relevant markets with and without the Isle of Grain as an importation facility. Frontier Economics has provided a market analysis based on a number of potentially relevant markets. The analysis considers the impact of the terminal under the following “worst case” scenarios:
- ◆ BP/Sonatrach hold all the rights to the initial capacity and no expansion capacity is constructed;
  - ◆ BP/Sonatrach does not exercise its option over a proportion of the expansion capacity and the capacity is awarded to the largest upstream player (assumed to be ExxonMobil);
  - ◆ BP/Sonatrach does not exercise its option and the largest downstream player takes all the expansion capacity (assumed to be Centrica); and
  - ◆ BP/Sonatrach acquires all the expansion capacity.
- 2.24. For the upstream market, Frontier Economics provides analysis on the UK wholesale market. Analysis by Frontier Economics shows that BP currently supplies 15% of gas to the UK wholesale market and Sonatrach currently does not supply any gas to the UK wholesale market. However, GLNG states that it is anticipated that Sonatrach will become a shipper on the NTS, taking gas supplied through the Isle of Grain LNG import terminal, to the UK wholesale National Balancing Point (NBP) market.

- 2.25. The study looks at market concentration<sup>13</sup> in the UK wholesale market and calculates the Hirschmann-Herfindal Indexes (HHIs)<sup>14</sup> post investment at Isle of Grain under each scenario. According to Office of Fair Trading guidelines a market with a HHI greater than 1800 is considered “highly concentrated”, whilst a market with a HHI between 1000 and 1800 is considered “concentrated”. The analysis shows that HHIs fall generally into the intermediate concentration range (they fall between 1028 and 1430). Despite mid range HHIs, Frontier Economics would not expect any of the scenarios to lead to a position in which the relevant party (BP, Sonatrach, Exxon or Centrica) accrued substantial market power relative to their present positions.
- 2.26. Frontier Economics suggests that the UK wholesale market is likely to remain competitive due to other market features. It is suggested that if planned projects materialise there is likely to be excess capacity and, in any event, the rapid additions to capacity expected would be likely to make any market power difficult to sustain. Frontier Economics suggests that any increase in the availability of capacity capable of delivering gas to the NBP statically must be good for consumers.
- 2.27. For downstream markets, Frontier Economics provides analysis on the UK retail markets and UK gas shipping. Frontier Economics analysis assumes that Sonatrach does not at this stage have any interests in the UK retail markets and this position is not forecast to change as a result of the project. Frontier economics analysis shows that BP does have some interests in the UK retail market with a 16.6% market share of gas supplied to power stations and a 15.4% market share of gas supplied to industrial and commercial customers. Frontier Economics suggests that BP does not supply any gas to domestic customers.

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<sup>13</sup> Market concentration indices are calculated on the basis of the shares of the volume deemed to go through the UK NBP. This includes all UK consumption plus the exports through the Bacton Zeebrugge interconnector.

<sup>14</sup> The Hirschmann- Herfindahl index is used as a measure for competitiveness in a market. It is the sum of the squares of the market shares of all companies in the market. The range of the index is therefore 0 (completely competitive) to 10,000 (monopoly).



- 2.28. Frontier Economics' analysis shows that for the supply of gas to power stations, BP has the second largest market share after BGT/Centrica and for the supply of gas to industrial and commercial customers BP has the largest market share. Frontier Economics suggest that the HHI for the power station gas supply market is 1351 and the HHI for the industrial and commercial gas supply market is 1179. These numbers fall into the intermediate concentration range. However, Frontier Economics suggests that these HHI's are still relatively low and, more importantly, barriers to entry in supply of gas to these markets are very low. Therefore Frontier Economics suggests that in relation to these markets no adverse competitive effects should be expected from the investments at Isle of Grain.
- 2.29. UK gas shipping is the use of the transportation network to move gas from the beach to its final use. For UK gas shipping, Frontier Economics suggests that there are at least 81 parties in possession of a UK shipping licence. Frontier Economics suggests that there are relatively low barriers to entry in the UK gas shipping market and there are extremely low barriers to expansion as a shipper which ensure that UK gas shipping remains a competitive market.
- 2.30. In summary, Frontier Economics considers that none of the relevant parties has a dominant position in the UK wholesale market and that any changes to the UK wholesale market associated with the developments at the Isle of Grain would not interfere with competition in the UK retail and gas shipping markets.

*A requirement to initially offer capacity to market*

- 2.31. GLNG argues that access to GLNG importation capacity has and will continue to be offered via a transparent and non-discriminatory open season process whereby the price paid for capacity is based on market valuations. Following an open season in which interested parties were invited to express an interest in the first phase capacity of 4.5bcm per year, BP and Sonatrach have jointly purchased this volume of capacity for a period of 20 years. The second phase of construction work will increase capacity up to 14.5bcm per year. The GLNG open season process for the second tranche of capacity

covered by this project has commenced and is very similar to that used in the first capacity offer.

#### *Effective secondary trading and anti-hoarding mechanisms*

- 2.32. GLNG suggests that it has proposed appropriate anti-hoarding measures and publication of relevant information to enable the market to make considered decisions with regard to secondary trading. GLNG explains that the contractual arrangements relating to the annual capacity charge paid by its customers should ensure that a primary capacity holder is fully incentivised to offer unutilised capacity to the secondary market. To facilitate this, GLNG has committed to developing a web site which will provide information such as plant availability, general access terms, ship vetting and terminal operating procedures, as well as a free form text bulletin board to facilitate secondary trading and sub-letting by a primary user. GLNG envisages that the bulletin board will be the primary mechanism for secondary trading and will facilitate sale of interruptible capacity by the operator to the extent this is not being utilised or traded by a primary shipper.

#### *Provision of Information*

- 2.33. GLNG notes that in accordance with section 19DA of the Gas Act 1986 in relation to provision of information to the Authority, it will provide information to Ofgem as required on an ex-ante and ex-post basis, for example, data on nominated and actual capacity utilisation. GLNG confirms that information on historical usage will be made available to Ofgem and where consistent with confidentiality arrangements it will also be made available publicly. GLNG has also agreed that it will release information to the market on a basis consistent with prevailing information disclosure requirements. GLNG suggests that appropriate ex-ante information will also be made available to Ofgem upon request.

#### **Economy and efficiency issues**

- 2.34. GLNG suggests that the Isle of Grain LNG import facility will benefit the internal European market by providing access to global LNG production, and

potentially substituting other non-UKCS gas supplies enhancing price competition in the UK. GLNG suggests that given the absence of any detrimental impact on competition it is difficult to conceive how the investments at the Isle of Grain could be considered to have any possible detrimental impact on the effective functioning of the internal gas market.

- 2.35. GLNG explains that the Isle of Grain LNG import facility will be party to Transco's standard terms and conditions in relation to connection to Transco's network (i.e. the Network Entry Agreements). GLNG explains that shippers bringing gas into Transco's network through the Isle of Grain facility will do so in accordance with Transco's network code.
- 2.36. GLNG explains that the importing shipper for the initial capacity will enter into a Transco Services Agreement. BP and Sonatrach were sold rights to 100 per cent of the initial importation capacity including all the existing tank space. Consequently, in order to ensure the safe and efficient operation of Transco's system and to enable Transco to gain consent from the HSE to convert the facility from its existing use as a storage facility, the successful shippers have entered into a gas supply arrangement to provide system reserve and transmission support services to Transco.
- 2.37. GLNG suggests that the Transco Services Agreement will help to underpin the safe and efficient operation of the Transco network through provision of system reserve and transmission support services. GLNG suggests that these services are similar in effect to those currently provided to Transco via the Isle of Grain storage facility. GLNG confirms that this change in arrangements has been accepted by the Health and Safety Executive as part of a material change to Transco's safety case.

### **Summary**

- 2.38. GLNG suggests that the introduction of an additional supply source through the Isle of Grain import terminal shifts the supply curve to the benefit of competition and therefore consumers, especially as GLNG suggests the UK indigenous supplies are rapidly declining. GLNG suggests that the

introduction of Sonatrach as a new entrant to the wholesale beach gas market will provide further benefits to competition. In addition, GLNG suggests that further enhancements to competition could result from the subsequent introduction of other new players to the UK market through additional open season processes. GLNG suggests that the Isle of Grain LNG importation terminal will be of positive benefit to competition and overall, GLNG is of the view that an exempt Isle of Grain project should not cause any material competition concerns in either the directly affected, or vertically related, markets.

- 2.39. GLNG argues that access to GLNG importation capacity has and will continue to be offered via a transparent and non-discriminatory open season process; that it has proposed appropriate anti-hoarding measures and publication of relevant information to enable the market to make considered decisions with regard to secondary trading; and it will comply with Section 19DA of the Gas Act 1986 in relation to provision of information to the Authority.
- 2.40. GLNG considers that arrangements have been made to ensure the Isle of Grain LNG importation terminal will be compatible with the internal gas market and the operation of the regulated system to which it is connected.
- 2.41. GLNG concludes that there is no conceivable scenario in which the investment at the Isle of Grain would be detrimental to competition, the operation of an economically efficient gas market or the efficient functioning of the pipeline system connected to the facility.

**(f) the Commission of the European Communities is or will be content with the exemption**

- 2.42. For the reasons outlined above GLNG considers that it satisfies the criteria for exemption. However, GLNG notes that it will ultimately be for the European Commission to determine whether this final condition is satisfied.

### 3. Ofgem's initial view

- 3.1. This chapter provides Ofgem's initial view on whether the Isle of Grain LNG import terminal meets the criteria contained in 19C(7) of the Gas Act relating to an exemption.

**(a) the facility or (as the case may be) the significant increase in its capacity will promote security of supply**

- 3.2. Ofgem notes that shippers bringing gas into Transco's network through the Isle of Grain facility will do so in accordance with Transco's network code. 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, for example, gas quality, but to the extent that there were, Ofgem would expect these to be resolved by GLNG and Transco. Ofgem therefore considers that the Isle of Grain facility should interact appropriately with existing arrangements that help to ensure security of supply.
- 3.3. Ofgem considers that the addition of a new source of gas will be beneficial for security of supply. Ofgem generally considers that efficient investment in LNG can significantly increase the diversity of import supply sources. In addition, Ofgem considers that the Isle of Grain facility should be beneficial for diversity of supply by introducing a new entry point. Ofgem would therefore expect this requirement to be met.

**(b) the level of risk is such that the investment to construct the facility or (as the case may be) to modify the facility to provide for a significant increase in its capacity would not be or would not have been made without the exemption**

- 3.4. Ofgem notes GLNG's assertion that without the expectation of an exemption the income assurances required to make the project viable would not have been sufficient when taking into account the significant risks associated with the project and NGT's view of the risk-reward balance.

- 3.5. Ofgem did not receive formal powers to grant exemptions until changes were made to the Gas Act 1986 on 26 August 2004. In the interim, in order to increase regulatory certainty for infrastructure project developers, DTI/Ofgem confirmed in the final views document published in November 2003 that Ofgem was prepared to consider applications from infrastructure project developers who were seeking early guidance on possible exemptions. The main investment decision relating to the conversion phase of the project for the Isle of Grain was made in May 2003. Therefore, at this time, the facility of seeking informal guidance was not available to GLNG and there was no route available for investors in the project to seek written guidance on a possible exemption.
- 3.6. However, given the advanced nature of the investment (ie. planned delivery early 2005), the DTI and Ofgem gave verbal reassurances to GLNG that it was likely that an exemption would be forthcoming if the facility was developed consistent with criteria in the proposed Directive. That is, Ofgem's view was subject to GLNG demonstrating that all capacity had been offered to the market, an effective UIOLI regime was in place for access to the LNG terminal and appropriate information gathering powers were in place. This was then reflected in GLNG's structuring of the project.
- 3.7. Ofgem notes GLNG's suggestion that the assessment as to whether this test is met or not needs to be applied at the point the investment decision was taken and not at the time the exemption application is submitted. We agree while the assessment is being made now, we are considering the position facing the NGT board at May 2003.
- 3.8. On this basis, Ofgem's initial view is that the initial phase of the project would not have been built without the comfort that exemption could be forthcoming. Ofgem is also of the preliminary view that an exemption is necessary for the second phase of capacity at the Isle of Grain importation terminal to proceed. Having taken into account GLNG's comments, Ofgem would expect this requirement to be met.

**(c) the facility is or is to be owned by a person other than the gas transporter who operates or will operate the pipeline system connected or to be connected to the facility**

- 3.9. It is clear that the Isle of Grain importation terminal is legally separate from Transco, the system operator. Ofgem would therefore expect this requirement to be met. However, work remains to be done for NGT to explain the operating margins contract between Isle of Grain shippers and Transco (see paragraph 3.20).

**(d) charges will be levied on users of the facility or (as the case may be) the increase in its capacity**

- 3.10. Ofgem considers that on the basis that the importation shippers will be charged an annual charge for the use of GLNG capacity, this exemption criterion is likely to be met. Ofgem's initial preference was that the charges were published. However, GLNG has explained that its throughput charges, while available to Ofgem, are commercially confidential. Therefore, at this point, Ofgem is not proposing that GLNG publishes its throughput charges but would welcome respondents' views on this issue.

**(e) the exemption will not be detrimental to competition, the operation of an economically efficient gas market or the efficient functioning of the pipeline system connected or to be connected to the facility**

**Competition issues**

- 3.11. The DTI/Ofgem documents explained that Ofgem would be looking at qualitative and quantitative factors with respect to competition in gas supply. Ofgem concluded that the regulatory authority should establish, at the outset of a new project, on the basis of a number of market indicators that the nature of the project and the relevant market conditions when taken together across the supply chain are sufficiently competitive to permit the granting of exemptions.

- 3.12. Ofgem has considered and broadly agrees with GLNG's views as to the qualitative nature of the UK market. That is that the Isle of Grain import terminal will not have a detrimental impact on competition. In respect of GLNG's quantitative analysis provided by Frontier Economics, Ofgem has several observations.
- 3.13. With respect to upstream competition, Ofgem agrees with Frontier Economics that despite mid range HHIs, Ofgem would not expect any of the worst case scenarios to lead to a position in which the relevant party (BP, Sonatrach, ExxonMobil or Centrica) - as a result of this exemption - accrued substantial market power relative to their present positions. Given this, Ofgem would expect customers' interests to be enhanced by the investment at the Isle of Grain as the most important effect of this investment is likely to be to shift the supply curve to the benefit of customers. In addition, Sonatrach 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 and thus can be seen as beneficial to competition.
- 3.14. As for downstream competition, Ofgem notes that Sonatrach does not at this stage supply any UK retail markets and this position is not forecast to change as a result of the project. Ofgem notes that BP does have some downstream interests. However, Ofgem agrees with Frontier Economics that the HHI's for the UK retail markets in which BP has interests are relatively low and no adverse competitive effects to these markets should be expected from the investments at Isle of Grain
- 3.15. In summary, Ofgem's initial view is that the Isle of Grain project should provide material benefits to upstream markets and that the project should have no material adverse effect on downstream competition.
- 3.16. Ofgem notes that GLNG agreed to conduct an open season in which parties were invited to express an interest in capacity from the first phase of the import terminal. Additionally, GLNG has also stated that it is holding another open season process for the second phase capacity. GLNG's decision to hold an initial open season, as well as its decision to hold an open season for the



second phase is an important part of Ofgem's assessment of this exemption application.

- 3.17. Ofgem also notes that GLNG has agreed to implement anti-hoarding measures and the publication of relevant information to enable the market to make considered decisions with regard to secondary trading. GLNG's decision to develop a website that is designed to facilitate secondary trading and sub-letting by the primary capacity owners is an important part of Ofgem's assessment of this exemption application.
- 3.18. It should be noted that Ofgem has not specifically approved the anti hoarding measures put in place by GLNG. It is not our intention to do so at this stage. However, should the arrangements put in place by GLNG result in primary capacity not being used, this could constitute grounds for reviewing the exemption.
- 3.19. For the avoidance of doubt, Ofgem's analysis has been carried out against the exemption criteria and is specific to the application for an exemption that Ofgem is considering. Any decision that Ofgem may make in relation to this application for an exemption does not preclude or impact in anyway on the operation of the Competition Act 1998. Further, as the analysis contained in this document is in relation to a specific situation, the analysis may or may not necessarily be relevant to a consideration of any related issues that may arise, for example under the Gas Act 1986 or the Competition Act 1998.

#### **Economy and efficiency issues**

- 3.20. Ofgem notes that Transco has replaced its operating margins and system support requirements at the Isle of Grain with the Transco Services Agreement. That is, Transco has replaced an internal agreement with an external agreement with the relevant shippers. Ofgem notes that this has been accepted by the Health and Safety Executive.
- 3.21. In contracting for these services, Transco must bear in mind that it has a statutory obligation to develop an economic and efficient system, and also that it has a licence obligation to ensure that its transportation business shall

not give or receive any cross subsidy to or from any other business of Transco or of an affiliate or related undertaking of it (Standard Condition 41 (Prohibition of Cross-Subsidies)). Clearly, these factors would have to be taken into account when contracting with a non-regulated NGT group company. For the avoidance of doubt, Ofgem has not approved the Transco Services Agreement. Ofgem has also not approved any change in the funding for operating margin and system support services that may result from these new contractual arrangements.

- 3.22. With this caveat with respect to the Transco Services Agreement, Ofgem does however consider that this criterion is likely to be met, given that the project is not detrimental to competition.

### ***Amendment or withdrawal of an exemption***

- 3.23. In all the documents published by the DTI and Ofgem on the award of exemption from RTPA, we have highlighted that there will remain grounds for amendment and, in extremis, revocation of an exemption. These grounds are:

- (a) there is a material decrease in the degree to which the requirements of subsections 19C(7)(a), (c), (d) or (e) of the Act are met with respect to the facility as the result of the direct action of the facility owner, facility operator, or throughputter;
- (b) the facility owner is declared bankrupt;
- (c) the facility owner is found to be in breach of the Competition Act 1998; or
- (d) there is merger or acquisition activity in relation to, or by facility owner, that is detrimental to competition

- 3.24. It is important to bear in mind that the analysis of the exemption request, and the subsequent review by the European Commission, has been undertaken on the basis of the facts put to us. Significant changes in this underlying data could represent grounds for review of the exemption.

3.25. That is not to say that an exemption will automatically be reviewed should there be material changes in the nature of the GLNG project. Rather, that it would be open to Ofgem to review the exemption.

### ***Summary***

3.26. In summary, Ofgem's preliminary view is that all the five criteria discussed above 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. Therefore, Ofgem's initial view is that it would be appropriate to grant exemption to the initial capacity of 4.5bcm for duration of 20 years and to the expansion capacity of 10bcm for duration up to 25 years from when commercial operations fully commence.

### **(f) the Commission of the European Communities is or will be content with the exemption**

3.27. Ofgem expects that as all of the five criteria described above seem likely to be met the European Commission should be content with the exemption.

## 4. Way forward

4.1. Ofgem will carefully consider responses received to this consultation on GLNG's formal request for exemption to help inform Ofgem's final views which will be submitted to the European Commission. As mentioned previously, 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 request that the regulatory authority amend its decision.<sup>15</sup> Providing that the European Commission does not veto the decision to grant an exemption, or request that Ofgem amends its decision, Ofgem would grant an exemption. A draft exemption order for Grain LNG Ltd is contained in Appendix 1.

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<sup>15</sup> This two month period may be extended by one additional month where additional information is sought by the Commission.

# DRAFT

## Appendix 1 Draft exemption order

### GAS ACT 1986

### SECTION 19C

### EXEMPTION

Pursuant to sub-section 19C(5) of the Gas Act 1986 (the Act), the Gas and Electricity Markets Authority hereby gives to Grain LNG Ltd<sup>16</sup>, as the owner of an LNG importation terminal, an exemption from the application of section 19D of the Act in relation to the LNG importation terminal located at the Isle of Grain, Nr Rochester, Kent, ME3 0AB subject to the attached Schedule.

The Official Seal of the Gas and Electricity Markets Authority hereunto affixed is authenticated by

**Steve Smith**

Authorised in that behalf by the

Gas and Electricity Markets Authority

Dated

# DRAFT

## SCHEDULE

### PERIOD, CONDITIONS, AND REVOCATION OF EXEMPTION

#### A. Interpretation and Definitions

In this exemption:

“the Authority” shall mean the Gas and Electricity Markets Authority established by section 1(1) of the Utilities Act 2000

“the Act” shall mean the Gas Act 1986

“the facility” shall mean LNG importation terminal

“facility owner” shall mean Grain LNG Ltd

“facility operator” shall mean Grain LNG Ltd

“throughputter” shall mean any primary capacity holder of the facility

#### B. Full description of the facility to which this exemption relates

The Isle of Grain LNG importation terminal with:

- a. an initial capacity of 4.5 billion cubic meters and;
- b. an expanded capacity of 10 billion cubic meters.

#### C. Expiry

Pursuant to section 19C(3)(a) of the Act, this exemption will cease to have effect:

- (a) in respect of the initial capacity of the facility, 20 years from the date that the facility commences commercial operation; and
- (b) in respect of the expansion capacity, 25 years from the date that the expansion capacity commences commercial operation.

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<sup>16</sup> Registered in England No. 4463679. Registered Office: 1-3 Strand, London, WC2N 5EHX.

# DRAFT

## D. Conditions

Pursuant to sub-section 19C(3)(b) of the Act, this exemption is made subject to the following conditions:

1. That the material provided by the facility owner to the Authority in respect of this exemption is accurate in all material respects.
2. The facility owner will notify the Authority within ten days of:
  - (a) the initial capacity of the facility commencing commercial operation; and
  - (b) the expansion capacity commencing commercial operation.
3. That none of the following events occur:
  - (a) there is a material decrease in the degree to which the requirements of sub-sections 19C(7)(a), (c), (d) or (e) of the Act are met with respect to the facility as the result of the direct action of the facility owner, facility operator, or throughputter;
  - (b) the facility owner is declared bankrupt;
  - (c) the facility owner is found to be in breach of the Competition Act 1998;
  - (d) there is merger or acquisition activity in relation to, or by facility owner, that is detrimental to competition.
4. The facility owner shall furnish the Authority in such manner and at such times as the Authority may reasonably require, with such information as the Authority may reasonably require or as may be necessary for the purpose of:
  - (a) performing the functions assigned to it by or under the Act, the Utilities Act 2000, or the Energy Act 2004; or
  - (b) monitoring compliance with the conditions contained in this exemption and the operation of the exemption.
5. The licensee shall make publicly available, in such manner and at such times as directed by the Authority, such information as the Authority determines is reasonable.
6. The facility owner, except in so far as the Authority consents in writing to its not doing so, complies with any direction given by the Authority (after the Authority has consulted Transco plc and the Health and Safety Executive) to supply to Transco plc such information as may be specified or described in the direction -
  - (a) at such times, in such form and such manner; and
  - (b) in respect of such periods, as may be so specified or described.

# DRAFT

Where the facility owner is prevented from complying with such a direction by an incident beyond its control, it shall not be treated as having contravened the condition specified in that paragraph.

In this condition -

- i. "Information" means information –
  - (a) relevant to the operation of the pipe-line system which is operated by Transco plc, and
  - (b) relating to –
    - i. the calorific value or the total quantity of gas expected to be conveyed or which could be conveyed during the following day from the facility; or
    - ii. any changes in such calorific value or total quantity as may be so specified;
- ii. "day" means the period beginning at 6 a.m. on one day and ending immediately before 6 a.m. on the next following day.

## E. Revocation

1. This exemption may be revoked by the Authority by giving a notice of revocation to the facility owner not less than four months before the coming into force of the revocation in any of the following circumstances:
  - (a) where, in the Authority's opinion, any of the events listed in paragraphs D3(a) – (d) above occur;
  - (b) the facility owner has failed to comply with a request for information issued by the Authority under paragraph D4 above and the Authority has written to the facility owner stating that the request has not been complied with and giving the facility owner notice that if the request for information remains outstanding past the period specified in the notice, the exemption may be revoked; or
  - (c) the facility owner has failed to comply with a direction issued by the Authority under paragraph D5 or D6 above and the Authority has written to the facility owner stating that the direction has not been complied with and giving the facility owner notice that if the direction remains outstanding past the period specified in the notice, the exemption may be revoked.