

Version for Public Consultation

Dragon LNG Limited

Application for an Exemption from Section 19D Gas Act 1986 (as amended by The Gas (Third Party Access) Regulations 2004 implementing Directive 2003/55/EC)

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1. Introduction

Dragon LNG Limited (“Dragon”) intends to construct an LNG importation and regasification facility (“the Facility”) at Milford Haven. Following an open season and negotiations between Dragon’s parent company, Petroplus Tankstorage International B.V., and a number of interested parties, capacity in the Facility is to be sold to two throughputters, BG Group and Petronas (“the Throughputters”).

The conclusion of definitive contracts for the sale of capacity on a long-term basis will enable Dragon to underwrite the investment and secure the necessary finance to proceed with the construction of the Facility. It will also enable the Throughputters to finalise necessary arrangements in the rest of the LNG chain, including the source of the LNG to be shipped to the Facility, the shipping arrangements to be put in place, and to be able to conclude downstream gas sales agreements with wholesalers, distributors and other end users. Both Dragon and the Throughputters are concerned to ensure that the capacity and the Facility will be granted an exemption from Section 19D Gas Act 1986, implementing Articles 18, 25(2), and (4) (the regulated tariff and third party access provisions of Directive 2003/55/EC of 26 June 2003) (“the Gas Directive”), as permitted in accordance with Article 22 of the Gas Directive. Such an exemption is considered justified, desirable and necessary for the investment decision by Dragon and the Throughputters, for the reasons set out in this paper.¹

Informal Views Process: Advance Legal Certainty was needed to progress project

Work on the project has been ongoing for some time. The parties faced a particular difficulty in that the implementation of the Gas Directive and the need for the granting of an exemption was to come into effect in the middle of the project development. Only once the Gas Directive was transposed into UK law would Ofgem formally acquire powers to grant exemptions, subject to the approval of the European Commission. However, the requirements for legal and regulatory certainty mean that Dragon needed to obtain, on as binding a basis as possible, a high level of comfort from both the UK regulatory authorities and the European Commission that an exemption would be granted on the terms requested when the implementing legislation was in place.

The scale of the advance commitments required for the Facility and the remaining parts of the LNG chains are such that Dragon and the Throughputters are unwilling to proceed without first gaining assurances that the Facility, including its planned expansions, will be exempted from regulation or mandated third party access for at least a minimum 20 year duration.

Dragon LNG submitted a request in March 2004 (“Informal Exemption Request”) to Ofgem to obtain comfort from Ofgem and the European Commission that the project would be eligible for exemption. Ofgem and the European Commission agreed to carry out an analysis of the proposed project in advance of the legislation coming into effect. Ofgem published its initial views document (“Ofgem Initial View”) in April 2004 and carried out a public consultation prior to publishing its final views “Ofgem Final Views”) in June 2004.

¹ 1. The parties are also concerned to ensure that Articles 20 and 25(3) will not be applicable. Ofgem confirmed in para 2.58 Final Views that an exemption from Article 20 and 25(3) was irrelevant. On that basis a request for exemption from those provisions is no longer included as part of this request. Should either Ofgem or the European Commission have changed its views on this point, the parties would wish the exemption to apply equally to Article 20 and 25(3).

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On 21 June 2004 Ofgem wrote to the European Commission seeking its views. The response, indicating that the conditions for an exemption as set out in the Gas Directive appeared likely to be fulfilled, was issued on 17 September 2004 (“Commission Comfort Letter”).

The overall result of the Ofgem and EU Commission exercise was that, as set out in Appendix 1 of the Ofgem Final Views, Ofgem confirmed that, in its view, the project met all the criteria set out in the Gas Directive to benefit from an exemption for the full duration of the throughput contracts relating to each development phase of the project.

The sponsors, namely Dragon, BG Group, Petronas and Petroplus, now wish to formalise the position of Ofgem and the EU Commission and obtain a formal exemption in order for the project to proceed, and hereby apply formally to OFGEM pursuant to Section 19(C) Gas Act 1986 (as amended) for grant of exemption from regulated third party access for the Facility.

Corporate Structure

The Petroplus company entering into the necessary agreements is Petroplus Tankstorage International BV’s parent company, namely Petroplus International NV, so references in this updated submission to “Petroplus” should be interpreted as referring to Petroplus International NV.

Since preparing and submitting the Informal Exemption Request the parties have identified that ownership of the Facility may need to be assigned at some stage from Dragon LNG Ltd to another company specifically constituted for such purpose. Any such new company would be owned, directly or indirectly, by BG Group, Petronas and Petroplus in the same proportions as Dragon LNG Ltd, and the construction, financing, and operation of the Facility would take effect with the new company in substitution for Dragon LNG Ltd.. The sponsors therefore specifically request that the exemption applied for is granted in respect of the Facility rather than solely to Dragon LNG Ltd, and is freely assignable to take effect in the event of such transfer of ownership.

Background Papers

In drafting this submission the following published papers have been found to be particularly helpful, and specific references will occasionally be made them.

Author	Date	Title
Flower & King, the Energy Publishing Network	June 2002	LNG Today: The Promise and the Pitfalls
Flower: the Energy Publishing Network	June 2004	LNG Today : 2004 Edition
Morgan Stanley – European Energy & Utilities: Cross-Industry Insights	14 November 2003	Gas Imports Fill ‘UK Gas Gap’ Without Price Crunch
Wood Mackenzie – Europe Upstream Insights	November 2003	The Timing of Gas Import Infrastructure to the UK

2. The Project

2.1 Details of the project

2.1.1 Overview and Background

Petroplus currently owns and operates a tank storage business at a site in Milford Haven, West Wales, which includes port facilities. This site formerly housed an oil refinery which closed in 1997. Petroplus purchased the site in 1998 and has been using it for oil storage. In 2001 Petroplus started to investigate the possibility of using the site to develop a new LNG facility (the "Facility"). It commenced discussions in 2001 in order to test potential demand for such a project. In 2003 it formed Dragon as a project vehicle, for the purpose of developing and ultimately owning and operating the Facility.

The Facility will be used to regasify LNG being imported into the UK by the Throughputters. Subject to achieving the necessary regulatory certainty, Dragon will enter into long term agreements ("Throughput Agreements") with the Throughputters pursuant to which Dragon will regasify and treat LNG imported by the Throughputters before it is piped into the national transmission system ("NTS"). A new 110km NTS high pressure pipeline necessary to accommodate the new Facility will be constructed by Transco. As is usual with LNG projects, Dragon intends the capacity at the Facility to be constructed in various phases. In the first phase, it is planned to sell 6 bcma² of capacity, to be made available in late 2007. Dragon is also granting options to the Throughputters over a further 6bcma which would require additional construction, taking the capacity of the Facility to 12bcma in due course.

Dragon's equity will be jointly owned by Petroplus and the Throughputters:- each Throughputter, wishing to bring to the project the benefit of expertise in other LNG projects and to ensure the smooth operation of the Facility, expressed an interest in acquiring shares in Dragon as well as purchasing capacity pursuant to the Throughput Agreement.

The Facility will be operated on a throughput basis by Dragon. In other words, Dragon will not itself purchase LNG for regasification, but will instead sell regasification capacity to each of the Throughputters through long-term contracts³. The Throughputters will retain title to the LNG at all stages through the regasification process and remain responsible for the offtake and onward sale of the resulting gas to the market. This has implications for the financing arrangements of the project, as the Facility will need to be self-sufficient with no element of cross-subsidisation between this and other parts of the LNG chain.

2.1.2 The Facility

The Facility will comprise the land, facilities, assets and rights belonging to, or operated by, Dragon for the receipt, storage and regasification of LNG and delivery of regasified LNG. A contract ("the EPC Contract") for the design, procurement, installation, construction and commissioning of the Facility, is being awarded through a competitive tender process complying with the requirements of the Utilities Contracts Regulations 1996 and the EU Council Directive 93/38. .

² Billion cubic metres per annum.

³ Dragon, for this and other reasons, is not considered to constitute a 'full-function' joint venture within the meaning of Article 3 of Regulation 4064/89/EEC (the Merger Regulation)

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The physical assets of the Facility will include some of the existing Milford Haven site, including a jetty and other infrastructure. New facilities to be initially built on the site within the scope of the Facility will include new unloading facilities, initially two cryogenic tanks each of 160,000m³ and a regasification unit, together with piping and metering facilities to the plant gate.

Petroplus received planning permission for the Facility in February 2003. This included permission to build two cryogenic tanks, enabling a facility to be constructed with a capacity of 6bcma. Planning permission for a third tank, enabling further capacity of 3 bcma, was received in September 2003. Planning consent is currently being developed for a fourth tank

A site plan of the Facility is attached at Annex 1.

2.1.3 Participants

The Facility will be developed only for the purpose of unloading, regasifying and treating imported LNG, and delivering it to the NTS. This is one part of an LNG supply chain that includes several stages: production of natural gas, treatment and liquefaction and shipping to the UK, regasification and onward sale to wholesalers, distributors, electricity generators or other commercial end-user customers.

Dragon is not itself involved in the stages of the LNG supply chain upstream or downstream of the importing and regasification element. Dragon will not itself buy LNG or sell gas. Dragon's revenues from the project will therefore consist exclusively in the charges and fees it is able to command from providing regasification services.

In order to find customers and partners Petroplus conducted an open season solicitation of offers to attract interest in the project. The open season process is described in Section 2.2. The existence of an open season was welcomed by Ofgem, as set out in para 2.13 Final Views.

Following the open season BG Group ("BG") were selected as one of the Throughputters. BG and Petroplus signed a Memorandum of Understanding on 12 November 2003. This provides that BG will contract for 50% of the initial 6 bcma of the capacity at the Facility, and gives BG an option to purchase an additional [•] bcma of capacity in an expansion. To help ensure the success of the project BG secured the agreement of Petroplus that BG could invest in the plant as an equity holder by purchasing 50% of the shares in Dragon. This enables BG to bring to the project the benefit of its expertise in LNG chains and in the design, construction and operation of LNG facilities.

Negotiations are ongoing with Petronas regarding a Throughput Agreement for the other 50% of the capacity. A Letter of Intent was signed between Petroplus and Petronas on 17 December 2003, which provides that Petronas will acquire from Petroplus, 50% of the initial 6 bcma of capacity in the Facility and 30% of the equity in Dragon. Petronas has also negotiated with Dragon an option to purchase an additional [•] bcma of capacity in an expansion. On 5th March 2004 Petronas signed a Heads of Agreement with Petroplus which expanded and developed the principles outlined in the Letter of Intent.

Dragon, BG and Petronas are currently finalising the throughput agreements and other binding agreements.

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The Throughput Agreements are structured as a sale of service capacity and oblige Dragon to receive at the Facility LNG in quantities up to a contractual annual maximum, regasify it and deliver it as gas into the NTS when nominated by the Throughputters. An important aspect of the negotiations was that the Throughputters needed regulatory certainty that their capacity rights will not be undermined.

2.1.4 Financing

Dragon will own, develop and operate the Facility, supported by project finance on a limited recourse basis. The financing aspects of the project are considered particularly important to Dragon, and this has implications, such as the need to ensure that all capacity in the terminal is sold, which are discussed further below.

In order to make the development of the Facility viable Dragon needs to ensure that full use of the capacity at the Facility will be contracted in advance on a long-term basis. We are advised by our financial advisors, Société Générale, that project financing to fund development of the Facility will only be made available to the extent Dragon ensures that the revenues from providing regasification services can be assured on a long-term basis.

A copy of the letter of advice received by Dragon from Société Générale is attached at Confidential Annex 4.

The Throughput Agreements will constitute the primary credit for the project financing of the Facility. It is intended that the Throughput Agreements will be in terms that will support a conventional limited recourse debt financing by Dragon of the Facility.

In addition to the investments required in other parts of the LNG chain, the estimated financing requirement for developing the Facility, including all cash expenses and interest during construction but net of the contribution of assets from the sponsors is over [•], all of which is to be provided under the terms of the project debt facility. The Participants have been basing their negotiations on the plan that the Facility will be financed in a manner that will allow [•] minimum recourse to the shareholders [•]. This has the following consequences, as set out further in Société Générale's advice to Dragon (see Confidential Annex 4):

- Lenders will only attribute value in their credit assessment of the Facility to revenues regarded as "reliable", i.e. capacity based revenues contracted under long term throughput agreements with identified experienced and creditworthy LNG operators, where such contracts are in place no later than financial close.
- The duration of the debt financing will depend on the duration of the exemption. Lenders will want to see the terminal exempted for the tenor of the financing plus a contract "tail" [•] to allow for the recovery of any project debt shortfalls towards the end of the debt life. For example, the proposed 20 year exemption from first gas delivery (expected 2007) will allow Throughput Agreements to be entered into for a period of 20 years. Depending on financing market conditions, this in turn will allow financing to be put in place for a period of up to [•] years from execution of financing [•], based on a debt tenor of [•] plus a "tail" of [•]. If the exemption is for a shorter period, the Throughput Agreements would need to be shortened. The tenor of the loan may also need to be reduced to ensure an adequate "tail" is available at the end of the financing period. A shorter debt tenor will imply higher annual debt service and

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hence either an increase of throughput tariff (thus rendering gas supplied through the Facility less competitive than alternative sources), or a reduction in the amount of debt available. The increased requirement for project equity funding that would result would be highly unattractive to developers and might prejudice the viability of the project for them.

2.1.5 Duration

Each of the Throughput Agreements will be for a term of 20 years. As shown above, such a duration is necessary for Dragon in order to secure the necessary certainty to finance the project as well as to mitigate the risks of the investment (i.e. that the capacity might remain unsold). It is also required by the Throughputters as it enables them to finalise agreements in other parts of the LNG supply chain. As LNG supply agreements are normally at least 20 years in duration⁴ and can be longer up to 25 years⁵ (necessary in many cases in order to provide the certainty to justify the investments and financing further upstream such as the liquefaction plants (typically \$1.5 billion⁶ for a 6 million tonne per annum plant (approximately equivalent to 8.5 bcma) and gas production fields (typically several hundred million dollars)), it follows that contractual arrangements at the regasification phase would have to have a similar term⁷. The features of the LNG chain are discussed in more detail in Section 3.1 below.

2.1.6 Expansion

As mentioned above, the capacity at the Facility will be brought into operation in two or possibly three phases – an initial capacity of 6 bcma followed by potentially a further 6bcma, as each Throughputter has been granted an option, exercisable within a period of [•] from project sanction (i.e. [•] from completion of Phase 1), to expand its share of the Facility by a further [•]. The timescale for the implementation of the expansion is not finalised, as it depends on market conditions. One possible timeframe is that one expansion of [•] will be sanctioned in 2007 and completed in 2010 and a second sanctioned in 2009 and completed in 2012, and this is the basis used for the financial figures presented in this submission.⁸

It is typical in the LNG industry to structure projects in phases and develop capacity at LNG regasification terminals in two or more stages in order to take account of market demand and

⁴ Flower and King, *LNG Today: 2004 Edition* (Energy Publishing Network: 2004) page 82.

⁵ Qatar has signed several LNG agreements of 25 years with buyers in Japan, Korea and India. Petroleum Economist “Fundamentals of the Global LNG Industry 2001” page 170.

⁶ Flower and King quote costs of \$250 per tonne of installed liquefaction capacity per year. The costs include owner’s costs, front end engineering and design but exclude financing costs. Flower and King, *LNG Today: 2004 Edition* (Energy Publishing Network: 2004) page 23.

⁷ On this point it is important to note that, although the Throughputters may have an interest in certain upstream LNG projects, neither of them is in a position in those projects to determine the destination of those LNG supplies or to decide where to source LNG, as they must respect the interests of third party joint venture partners and/or the wishes of the appropriate government. In other words, the proposed Throughputters cannot be certain that they will secure LNG supplies from any particular source until contractual arrangements are negotiated with the LNG suppliers

⁸ For simplicity and ease of comparison, the market share figures assume that *both* expansions will be operational by 2010. This is not felt to be the most likely scenario, but does show the maximum possible upward impact on market shares.

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to optimise the use of investment capital. The large fixed costs involved in developing an LNG supply chain from wellhead to terminal outlet mean that economies of scale are essential to ensure profitability. However at the same time it may not be possible for a market to absorb at once all the LNG produced when such economies of scale are achieved. Given the time and costs involved to bring on new LNG capacity, developments must be synchronised throughout the chain including matching new liquefaction capacity with regasification capacity and the ability of the target market to absorb additional volumes. For this reason it is common for both LNG suppliers and LNG importers to have an overall plan at the time of the initial investment for phased, incremental expansions of capacity as the market grows and new upstream supplies of gas can be developed to bring on the new LNG supply. This approach enables LNG suppliers to manage their market risk, whilst ultimately attaining the necessary economies of scale.

This is the approach at several existing LNG regasification facilities such as: Huelva in Spain (currently 4 bcma, potential of 12 bcma); Zeebrugge in Belgium (currently 5 bcma, potential of 9 bcma); and the proposed Exxon Mobil, South Hook facility, where the capacity will be 10.5 bcma in Phase I, with a further 10.5 bcma added in Phase II

To bring an expansion online, however, will require additional financing as well as long term security of availability of capacity in order to build the applicable LNG chain, in the same way as the initial construction. Although some might regard the expansions as a new piece of infrastructure, the Throughputters take a different view and made clear during the Open Season and their negotiations with Dragon and Petroplus that the attractiveness of the initial capacity offering depended, among other things, on an expansion option being available. This is for several reasons. Firstly, the financial returns are only attractive to the Throughputters if the expansions are realised (see Annex 4), as the returns on an initial 6bcma Facility are in themselves not particularly attractive. Secondly, as mentioned above, it is a common occurrence in the industry to construct LNG Facilities in various stages to allow for economies of scale to be realised. Thirdly the Throughputters have a strong preference that their additional capacity requirements are met in one and the same terminal, rather than needing to seek access and agree contractual and scheduling regimes in other terminals, which would lead to increased costs in managing a wider range of relationships.

For this reason Dragon is keen to ensure that it can offer the Throughputters the maximum possible legal certainty that the expansion options are validly granted, and is therefore requesting that the exemption covers not only the initial capacity but also the two possible expansions.

If exemptions are granted now only for the Phase 1 capacity, and not for the expansions, then this will raise particular difficulties:

- If the risk remains that the planned expansions of the Facility will not themselves benefit from an exemption, the Throughputters will themselves be unable to negotiate expansion options on the LNG supply and will have less certainty in their ability to put together appropriate LNG chains.
- Financiers will be concerned to understand the impact of a future, unknown regulatory regime not just on the potentially regulated expansions but also its implications on the original Phase 1 capacity. For example, if a planned expansion is not exempted and necessitates additional shippers being granted access to the Facility, this will have an impact on the operational certainty and therefore the throughput

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revenues attributed by the lenders to the Phase 1 capacity. Such uncertainty would impact the financing provisions of the initial capacity itself.

For these reasons Dragon is seeking the minimum duration of the exemption to be such as to permit 20 years Throughput Agreements to be entered into for each phase.

2.2 *Open Season Procedure*

Petroplus followed an open season procedure (“the Open Season”) to attract partners to the project. In all Petroplus has had discussions with 28 parties regarding a possible participation in Dragon, including parties which approached Petroplus on their own initiative. Petroplus’ proposal for an LNG terminal at Milford Haven has also been covered in the trade press.

Starting in 2001 Petroplus approached companies in order to test out levels of interest. These companies included national oil companies, integrated major oil companies, gas shipping companies, energy trading companies and independent oil and gas companies. Meetings were held with all of these organisations.

In September 2002 Morgan Stanley was retained as Petroplus’ financial adviser to help in the solicitation of potential Throughputters. Morgan Stanley reviewed each potential partner against a range of relevant criteria and recommended a “long shortlist”, to each of which a formal solicitation letter was sent. Morgan Stanley’s solicitation letter sent on behalf of Petroplus is attached at Annex 2.

The criteria, which were made clear to the solicited parties, were as follows:

- acceptance of the commercial framework outlined in the solicitation
- the company’s preferred role in the customer relationship with the Operator.
- acceptance of a preliminary term sheet for throughput
- the volume of contracted annual throughput capacity in which the company would have an interest (subject to a minimum of 2 bcm per annum) and any seasonal variation in demand
- earliest possible and latest preferred start-up dates for delivery.
- the company’s preferred Throughput Agreement term – subject to a minimum of 15 years from first offtake.
- the company’s potential interest in the purchase of an equity stake in the Facility
- any other information the company considered may be relevant to Petroplus in determining its choice of Throughput Agreement partner

In addition, further questions solicited information on the proposed sources of LNG and downstream marketing of gas. These questions varied depending on whether a party was seen as an LNG supplier needing a relationship with a UK gas marketer, a market company needing a source of LNG, or an integrated company with a presence in both the upstream and downstream parts of the chain.

Twelve potential partners were identified following this process as having a firm interest in the project and as being viable candidates with respect to their supply of LNG and demand for gas capabilities. All were independent of Petroplus.

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[•] potential partners were short listed following consultations with and responses from the twelve parties. Those [•] best met the objective criteria set out above. The [•] parties were each invited to present clear priced proposals for their participation as throughputters, on the basis of offered outline terms, with or without equity participation.

Of the responses received, [•]two were positive and broadly conforming, in each case at prices slightly below those proposed by Petroplus.

While this formal solicitation process took place, contacts at a lower level with other potential participants were kept alive. It was recognised that although the competitive open season process should be transparent and fair, there were uncertainties about its outcome. The project, the process and even the industrial sector (LNG import) were all new to the market, and so it was prudent for Petroplus to keep contacts alive, particularly as it was clear from discussions that different parties' appetite for a role in the project changed over time. Some parties were enthusiastic until asked to make a definitive offer, when they changed their minds; others, having been uninterested, were returning to Petroplus to ask to be considered for a role at a later stage in the offering when the commercial shape of the project was clearer.

Against this background, commercial arms length negotiations were undertaken with BG as the preferred party expressing interest in up to 6 bcma of throughput capacity. Negotiations with BG were extended, particularly in respect of the terms of sale of equity to BG. An extensive Memorandum of Understanding was executed with BG in November 2003, setting out the terms of sale of 3 bcma of throughput capacity in the terminal on a 20-year basis. The Memorandum of Understanding also included an option for a further [•] of expansion capacity. The terms of such sale were substantially the same as those offered by BG in April 2003 in its response to Petroplus's request for priced proposals.

In July 2003, in the course of maintaining touch with the wider market, Petroplus discussed a possible role in the project with Petronas. Although in preliminary contacts in 2002 Petronas had shown little interest in the project, in the intervening year its views had changed, and it was now keen to receive the solicitation package. Given that negotiations with BG were non-exclusive, and that BG's immediate interest was in an initial throughput volume of only 3 bcma, this was an appropriate and prudent discussion for Petroplus to undertake.

Petronas responded positively to the solicitation and on 17 December 2003 executed a Letter of Intent in outline terms to participate in the project both as throughputter of an initial 3 bcma and purchaser of a 30% shareholding but made it a condition of participation that it has the right to expansion capacity, of [•]. Petronas signed a Heads of Agreement with Petroplus on 5th March 2004 which developed the principles contained in the Letter of Intent.

2.3 The Parties

2.3.1 Petroplus

Since it was established 10 years ago, Petroplus has developed into an important player in the European midstream oil market. The midstream sector encompasses refining, marketing and logistics (predominantly tank storage).

Petroplus has built up a pan-European portfolio of activities. It is the owner of refineries in Antwerp (Belgium), Cressier (Switzerland) and Teeside (United Kingdom) with a total

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capacity of 270,000 barrels a day. Petroplus International NV is publicly listed in the NextPrime segment of Euronext, Amsterdam.

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

On 6 September 2004 Petroplus' parent company, Petroplus International NV, issued a joint press release with RIVR Acquisition BV, confirming that the European Commission had approved the intended public offer by RIVR to acquire the Petroplus group⁹. The intended public offer has yet to be launched but if this acquisition is completed it should not raise any concerns or make any difference to the competitive situation of Petroplus or Dragon. RIVR is a special purpose vehicle controlled by the Carlyle Group, and the Carlyle Group does not currently control any other gas producer, distributor, wholesaler or retailer within the EEA.

Details of Petroplus' activities can be found on its website- www.petroplus.nl

2.3.2 BG Group

BG Group is a leading gas company with activities in over twenty countries. Its principal businesses are the exploration and production of gas and oil, liquefied natural gas, transmission and distribution, and power generation. BG Group headquarters are located in Reading, Berkshire. The company employs around 4,500 people worldwide.¹⁰

The company has four major business segments: Exploration and Production, which is comprised of exploration, development, production and marketing of hydrocarbons with a focus on gas; Transmission and Distribution, which develops, owns and operates major pipelines and distribution networks and supplies gas through these to the end customer; Power Generation, which develops, owns and operates natural gas-fired power generation plants around the world; and LNG.

BG's LNG business combines the development and use of LNG import and export facilities with the purchase, shipping and sale of LNG and regasified natural gas. The company has been involved in developing LNG projects in Trinidad & Tobago, Egypt, Italy, India, Bolivia and Iran. BG currently has interests in three LNG importation and regasification facilities. In the US, it has bought capacity (but no equity) on a long-term basis at Lake Charles in Louisiana, USA and in Elba Island in Georgia, USA. In a joint initiative with KeySpan Corporation, BG is also proposing an upgrade to facilities in Providence, Rhode Island, USA, which, subject to FERC approval, will result in additional US capacity for BG. In Europe, in addition to the Dragon project, BG is involved in the development of an LNG regasification terminal at Brindisi, Italy, which is expected to become operational in 2007.

Full details of BG Group's activities can be found on its website: www.bg-group.com, including the most recent Annual Report and the most recent "Data Book" showing BG's activities and interests around the World.

⁹ Decision of 1 September 2004 in Case COMP/ M.3478- RIVR/Petroplus

¹⁰ To avoid any potential confusion, it should be noted that BG Group is unconnected with the entity now known in the United Kingdom as "British Gas", which is a trading arm of Centrica plc.

2.3.3 Petronas

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

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

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

More information on Petronas can be found at www.petronas.com.

3. The LNG Business

3.1 The LNG Chain

The LNG industry is based on a production and distribution method which is very much part of one indivisible process. “Each LNG project consists of a continuous chain of activities linking the gas production to the gas user. Links in the LNG supply chain include upstream (gas production), liquefaction, shipping, regasification, and distribution (as natural gas) to end-users.”¹¹

There is a general understanding in the LNG industry that large investments are required at every part of the LNG chain and in order to remain cost competitive, the various elements of the chain need to be linked together seamlessly into a continuous chain process.

The Dragon Facility, once operational, will provide regasification capacity which will be used to ensure access to the UK market for LNG supplies contracted on a long-term basis from one or more upstream LNG suppliers. If the Facility is not available to take the deliveries (due to, for example, scheduling or other operational difficulties) the whole process is undermined.

As described in Section 2.1.3, it is not intended that Dragon will itself buy LNG or sell gas. Unlike an “own use” terminal, at the Dragon Facility the Throughputters are reacting to a competitive process set out by Dragon and are not buying capacity in order to secure a delivery point for an already finalised source of LNG production. Indeed, timing of the process was such that neither BG nor Petronas was in a position to finally identify the source of the LNG prior to bidding for capacity. This has two main consequences:

¹¹ Flower, *LNG Today: 2004 Edition* (Energy Publishing Network: 2004) page 1.

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- 1) The Facility needs to ensure that it is viable, financeable and ultimately profitable on its own terms, bearing in mind that its revenues will consist solely of tariffs and other fees charged to the Throughputters for use of regasification capacity. It is not possible for the Facility to be cross-subsidised from returns made in other parts of the chain.¹²
- 2) Nevertheless, the construction of an LNG chain will depend on the Facility being able to give a level of certainty to the other parts of that chain (gas customers, LNG suppliers, their governments and financiers) that it will be run as an efficient, cost-effective and reliable operation. Upstream producers will only be able to obtain financing for their own projects to the extent they are able to enter into long-term, legally certain contracts for LNG sales to the Throughputters.

The Throughputters are currently in negotiations with [•]LNG suppliers. However, in order to secure such supplies they will need to enter into long-term contracts and must therefore be in a position to secure long-term capacity in the terminal.

3.1.1 Production and Liquefaction

The first part of the LNG chain involves the exploration, development and production of the natural gas at its source. To be feasible, LNG projects require large reserves of gas, typically a minimum of 10 trillion cubic feet (approximately 280 bcm) for a world scale LNG project with capacity of around 8 million tonnes per annum¹³, and be able to produce gas at a plateau level for at least 20 years. After gas has been produced, it is liquefied by processing and cooling to -161°C. The investments required in this stage of the process are very substantial, requiring \$1-2 billion for the development of the upstream fields and liquefaction facilities.

3.1.2 Transportation

After liquefaction, LNG is transported in specially built LNG tankers. Most LNG tankers in operation today have a capacity of 125,000 m³ to 140,000 m³.

Depending on the source of the LNG supply for the Dragon project, each Throughputter will probably need 2 or 3 LNG tankers, at a cost of approximately \$150 million each.

[•]Once capacity in Dragon has been definitively allocated to BG, BG will be able to finalise the source of the LNG supply and will then need to put in place contracts for shipping. [•].

Petronas intends to utilise the shipping fleet of Malaysian International Shipping Corp.(MISC) (in which Petronas is a majority owner).

¹² Even if the Throughputters secure LNG supplies from upstream operations in which they have an interest (eg. Egyptian LNG) the presence of other shareholders or stakeholders both in the Facility (Petroplus) and in the upstream operations (e.g. the Egyptian government) prevents the Throughputters from being able to cross-subsidise.

¹³ Flower, *LNG Today: 2004 Edition* (Energy Publishing Network: 2004) page 19.

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3.1.3 Importation and Regasification

Once the LNG tanker arrives at its destination, the LNG is unloaded at a receiving terminal where it is stored and regasified for distribution through the transmission network to users.

As for all such projects, it is crucial for BG and Petronas that the facilities and capacity at Milford Haven are fully compatible with the process of producing and shipping the LNG. This level of compatibility is also necessary to ensure that operating cost efficiencies are optimised, resulting in lower throughput charges and helping to ensure the viability of importing LNG to the UK.

The Facility is being designed for production purposes and not as a storage facility. Short term storage is needed at the Facility in order to be able to unload the LNG tankers as quickly as possible and free them up to commence their return journey to the LNG source. The stored LNG is then regasified and supplied to the National Transmission System pending the arrival of the next tanker, with the aim that the storage tanks are sufficiently depleted by the time the next tanker arrives that the incoming tanker can commence unloading immediately. If not correctly timed, tankers can end up waiting for jetty space and/or waiting at jetty for space in the storage tanks, which is inefficient and increases costs. Dragon does not intend to offer storage facilities separately from regasification services.

3.1.4 Transmission to the Network

The final stage in the LNG chain is transmission of the regasified LNG to the transmission system and ultimately to the end user.

A new pipeline will be required to connect the Facility (and the competing Exxon-Mobil facility which is also planned to be constructed at Milford Haven) to the Transco owned National Transmission System ("NTS"). Arrangements for this are the responsibility of Transco. Separate negotiations are currently ongoing between Transco and the potential users of the new pipeline.

3.2 Regulatory Issues in the Importation/Regasification Stage

The operational and commercial arrangements of the Facility have been based upon a 100% capacity exemption. Placing a requirement on Dragon to provide for a further allocation of capacity to third parties other than BG and Petronas would raise costs and would create significant operational constraints and increase risks for the development of the Facility, as follows:

a) Feasibility studies conducted by Dragon on the site, market demand for gas, shipping constraints, and planned facilities lead Dragon to take the view that the optimal initial size of the facility is 6bcm. It was on this basis that 6bcm was offered for sale in the Open Season, and each Throughputter has indicated that it wishes to purchase 3bcm initial capacity. If Dragon is required to offer additional capacity to third parties it will need to redesign the plant. The entire basis of the discussions and preliminary commitments of throughputters and equity participants is that the full baseload capacity of the terminal will be contracted on a long-term basis. This is currently the only basis on which the sponsors can be confident that the project will proceed.

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Nevertheless Dragon has been asked to consider the feasibility of an exemption based on only 80% capacity. On this scenario, the plant would need to be expanded to 7.5bcma in the initial stage to ensure that Dragon was in a position to offer 6bcma to the Throughputters as offered in the Open Season. This will involve additional costs which cannot be underwritten by Dragon, as there is no guarantee that such capacity will be sold. Since lenders will not take into account revenues at financial close which are not underpinned by long term Throughput contracts, a requirement that Dragon go ahead on the above basis would reduce the returns to shareholders or would require Dragon to charge higher tariffs to the long term Throughputters. This would either render the Facility less attractive to developers or would make LNG imported via Dragon less competitive than other sources of supply, making Dragon less attractive to the Throughputters. If such changes are to be considered, the sponsors cannot be sure that the project will proceed. Even if such changes could be accommodated, the sponsors fear that a delay in project implementation of at least a year and possibly longer would result.

b) Even if Dragon changed its mind and were prepared to underwrite (and self-finance) the construction of additional capacity, Dragon has already tendered for an EPC contract for the design and construction of a 6bcma plant. The expansion to 7.5 bcma would require a redesign of the Facility and a new EPC tender process to be recommenced from scratch meaning that Dragon would no longer be in a position to sell capacity to BG and Petronas in the near future. This has consequences for the timing and therefore the viability of the project as a whole (see below).

c) Alternatively, assuming Dragon maintains the current sizing of the Facility, an obligation to provide for a further allocation to third parties would mean that it is only in a position to offer 2.4 bcma Phase 1 capacity to each of BG and Petronas. Neither BG nor Petronas have expressed any interest in acquiring a more limited volume of capacity; as this would present corresponding restrictions on BG and Petronas' plans further upstream in respect of purchasing LNG and shipping. Again, delays to the negotiations risk the viability of the Facility as a whole.

d) Dragon is not in a position to be able to reserve capacity for short term sales as such sales will not be taken into account by financiers for the purposes of financing and neither Petroplus nor the new potential shareholders are willing to underwrite such risks themselves. As noted above, a requirement to go ahead on such a basis would require either a reduction in the returns to shareholders or would require Dragon to charge the Throughputters higher tariffs. Both alternatives would make the Dragon project less attractive.

e) The timetable for financing the project is crucial to the project's success. As noted above financiers will only take into account revenues underpinned by long term Throughput Agreements. If Dragon was required as part of an exemption to provide 20% capacity for other throughputters, the only way financiers would take any revenues from this capacity into account would be if additional long term Throughput Agreements had been signed with third parties. Dragon does not believe it will be possible to put in place additional Throughput Agreements with third parties within the timescale envisaged for project financing. Delay could mean that the project misses its targeted operational date, increasing the market risk to the Throughputters, and thus the reducing attractiveness and viability of the project.

f) Granting third party access to other throughputters will create additional operational problems. For operational and scheduling reasons Dragon believes more than two shippers could be difficult in the initial stages as it could make it more difficult for Dragon to meet its

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contractual commitments to each of the Throughputters (for example a slight delay by one Throughputter taking longer to unload at the jetty than envisaged could result in much longer delays for another Throughputter with a different shipping schedule). For this reason Dragon believes it would be preferable, at least in the initial period, to limit the number of throughputters to two. Société Générale have themselves indicated that financiers will require certainty about how the Facility will operate. Dragon believes lenders may object to capacity being granted to additional throughputters if this is likely to raise concerns that Dragon will not be able to meet its contractual commitments under the existing Throughput Agreements.

g) The need for exemption in the near future needs to be stressed given the timing sensitivities of the Facility. Publicly available sources, such as the Morgan Stanley report published 14 November 2003 “Gas Imports Fill UK Gas Gap without price crunch” show that a large variety of projects are currently being considered to bring additional gas supplies to the UK in order to fill the expected supply gap forecast to commence in 2007. In addition to the LNG terminals already mentioned, there is the Gasunie BBL pipeline, the Ormen Lange development and associated pipeline, expansions to the UK-Belgium interconnector to expand the reverse flow, and the use of existing pipelines to import gas from Norway. Indeed, Wood MacKenzie estimate in their report “The Timing of Gas Import Infrastructure to the UK” that, if all planned projects are realised, new capacity in excess of 100 bcm per annum would be created.

The UK market cannot support such a large increase in capacity. This means that only projects which can be sanctioned quickly are likely to be built, as “latecomers” are likely to lose their credibility and become less attractive to financiers once it is known that the supply gap is being met by other means. This is another reason why legal comfort for Dragon is required as soon as possible. If delays occur in achieving project sanction then Dragon may no longer be in a position to achieve operational start-up in 2007. Such delays will threaten the viability of the project as a whole.

h) Finally, Dragon wishes to point out that all capacity in the Facility has *already* been offered to the market under the Open Season process. In its final views paper on the regulatory regime for LNG facilities and interconnectors¹⁴ (the “Final Views Paper”) the DTI and Ofgem stated, “a demonstration of an initial offer of capacity to the market can help support the case in relation to the competition assessment ... and ... could address any possible concerns in relation to the sizing of the facility.”¹⁵

The Ofgem letter to Dragon dated 23 June 2004 (reproduced as Annex 1 of the Final Views) also recognises this, where it states “The decision of Petroplus to undertake an open season is a positive factor in our consideration of Dragon LNG Ltd’s draft application.”¹⁶

Dragon believes that any concerns which Ofgem or the European Commission could have regarding the Facility, can be remedied by including in the exemption relevant anti-

¹⁴ DTI/Ofgem final views, *LNG facilities and interconnectors: EU legislation and regulatory regime*, November 2003.

¹⁵ The Final Views Paper at paragraph 4.29.

¹⁶ page 17 Appendix 1 Dragon LNG Ltd: Draft Application for an exemption for the Milford Haven LNG import terminal. Ofgem Final Views June 2004.

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hoarding/UIOLI and information provisions. Dragon recognises that built capacity should be utilised effectively and we are prepared to give a commitment, as part of the exemption, that provides for unused capacity rights to be traded and ensures that any spare capacity can be offered to the market.

The anti-hoarding/UIOLI and information provisions proposed by Dragon are set out in Section 6 below.

4. Competition Analysis

Two of the five exemption conditions in the Gas Directive relate to the impact of the investment on competition. Article 22 of the Gas Directive stipulates that the investment must “enhance competition in gas supply” and that “the exemption is not detrimental to competition.”

In this section, Dragon sets out its views on the definition of the relevant markets and the level of competition in those markets. Other possible market definitions are also considered. The analysis shows that, no matter which market definition is adopted, the proposed project will not be detrimental to competition and will, in fact, enhance competition in gas supply. This section has also been updated since the informal exemption request to include updated market figures and to take account of Ofgem’s view, as expressed in Paragraph 2.10 Final Views, that BG’s share of the downstream market should include market share as a result of its supplies to power generators.¹⁷

4.1 The Relevant Markets

As noted by the DTI and Ofgem in the Final Views Paper, “the possible difficulties surrounding the definition of the relevant market reinforce the need for any exemption application a developer submits to include its own competition assessment.”¹⁸

It is Dragon’s view that the relevant product and geographic markets affected by the project can be summarised as follows:

Product Market	Geographic Market
Production and supply of natural gas to distributors, wholesalers and large commercial end-users	Includes UKCS gas and at least EEA, Russian and Algerian sources as well as all LNG sources into EEA
Downstream sales of natural gas to domestic and small commercial end users	National

Dragon notes that the appropriate market definition proposed by Qatar Petroleum and ExxonMobil Qatargas (II) Limited in their recent exemption application¹⁹ included a UK wholesale market. Dragon also notes that OFGEM’s initial views on that application state at para 2.31 that the relevant figure is the total physical supplies of gas when set against total physical deliveries. If, for the purposes of calculating market share, only physical, rather than traded volumes, are taken into account, then it appears to Dragon that there would be no material difference in market share figures for BG and Petronas between the wholesale

¹⁷ BG had previously included such sales as part of its calculations of market share in the wholesale market

¹⁸ The Final Views Paper at paragraph 5.15.

¹⁹ *Informal Application for Exemption from Regulated Third Party Access to UK LNG Facilities: Proposed LNG Terminal (“South Hook”) at Milford Haven, 26 November 2003 (referred to herein as the “South Hook Application”).*

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market and the upstream “production and supply” market as neither BG Group nor Petronas trade volumes other than as an ancillary activity to their sale of production volumes. Therefore, for the purposes of this paper the wholesale arena is not treated as being separate from upstream supply. In any event, if there were a separate wholesale market independent of the upstream supply market, the effect of this transaction would be to increase liquidity by ensuring that additional supplies of gas are capable of being traded on that market.

Dragon agrees, nevertheless, that the existence of a liquid, traded market for gas at the National Balancing Point (NBP) effectively de-links control of upstream gas supplies from the downstream markets regardless of respective market shares. This point is worth stressing, particularly in relation to any possible concerns over downstream market shares of customers of the LNG, and is discussed further below.

Dragon notes that Ofgem requested Exxon-Mobil to provide information on a narrower basis, namely based on gas sources expected to flow into Great Britain. Dragon is pleased to provide estimates of BG Group’s and Petronas’ market share on this basis, although we agree with the view submitted by Exxon-Mobil in their exemption request that the geographic upstream market is considerable wider.

An analysis of competition in these relevant markets both before and after the project is set out at Sections 4.3 and 4.4 below. This illustrates that the investment will enhance competition and that the exemption will not be detrimental to competition.

However we also aim to show, even if a narrower market definition is taken, the investment will still enhance competition and the exemption will not be detrimental to competition. Therefore Section 4.2 considers the competitive impact on the UK gas supply chain and shows that even if the relevant markets are defined in UK terms there is a competitive benefit. Finally, the analysis in Section 4.5 shows that taking the LNG supply chain by itself, the result is the same.

4.2 The Supply of Gas in the UK

4.2.1 Market Segments

The gas supply chain in the UK can be segmented into three tiers: upstream supply, sales at the wholesale level and downstream supply of gas.

Upstream and Wholesale

The upstream level includes all supplies of gas to the UK. The current sources of gas to the UK are the North Sea and Irish Sea gas fields, imports from Norwegian fields and imports via the Bacton interconnector with Belgium. As discussed by the Wood Mackenzie report on The Timing of Gas Import Infrastructure to the UK, several other sources of gas are being developed, including the BBL interconnector with The Netherlands and three LNG import facilities – South Hook in Milford Haven, the Isle of Grain and the Facility.

Gas from the North Sea and Irish Sea fields is purchased by shippers (and suppliers) who can take title to the gas either at the onshore coastal reception terminal (‘beach gas’) or at the National Balancing Point (“NBP”). In fact they can take title at any point upstream of the NBP.

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Gas producers may sell gas directly or indirectly to other gas suppliers (or power generation or large industrial customers connected directly to the NTS)²⁰.

National Balancing Point Trading

Most gas trading at the wholesale level takes place at the NBP, with the seller having obtained entry capacity on to the NTS. It is important to highlight that this mechanism, whereby there exists no physical location to which gas needs to be transported in order to be traded on the UK market, effectively de-links control of upstream gas supplies from downstream markets. Trading at the NBP effectively represents approximately 13 times the physical volumes in the NTS. The existence of such a liquid market ensures that Downstream players have access to gas on a ready basis, and long or medium-term contracts which may be entered into even with larger downstream resellers will not have a foreclosure effect on the gas available to other downstream players.

Transco sells entry capacity in an auction process and there is also a secondary market for entry capacity. Traded markets for gas in the UK include the On the day Commodity (“OCM”) market through which traders, shippers and Transco buy and sell gas for the current day and the day ahead; the Over the Counter (“OTC”) market which can be on the basis of day trades or over longer periods extending to around five years; and the International Petroleum Exchange (IPE) on which gas futures are traded – in addition, derivatives such as options and swaps are traded bilaterally. These various markets and traded products enable suppliers of gas to match their supplies with the aggregate demand of their customers. For example aggregate demand can change due to weather or due to customers switching to different suppliers.

Downstream

The downstream part of the gas supply chain can be divided by type of end-user into two segments: industrial and commercial users and domestic users. Most industrial and commercial customers as well as domestic users obtain their supplies of gas from licensed gas supply companies.

4.2.2 The UK Gas Supply Chain is Characterised by a Competitive Nature

UK is the most competitive country in Europe

The UK market for the supply of natural gas is widely considered to be one of the most competitive in the world. In Europe, the UK is ahead of all other countries in terms of liberalisation, unbundling and the level of competition. The International Energy Agency has said that “the liberalisation of the downstream gas industry . . . is now very successful”.²¹ The report goes on to say : “The complete opening of the gas market to all consumers successfully created competition, as is shown by the number of companies which are active in the market,

²⁰ Gas-fired power stations are mostly connected directly to the NTS and increasingly purchase gas on the wholesale level. For this reason supplies to power stations are viewed here as part of the upstream market.

²¹ International Energy Agency “Energy Policies of IEA Countries : The United Kingdom 2002 Review” page 104

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including the market to serve final consumers, and by the large number of customers who have used the possibility to switch their supplier”.

In its Second Benchmarking Report on the Implementation of the Internal Electricity and Gas Market published in April 2003,²² the European Commission highlights the fact that the UK has the most competitive market in Europe. It stresses that in the UK there has been “full and effective market opening [and] prices to domestic users have been kept relatively low.”²³ The report shows that the UK has the highest level of switching or renegotiations of contracts by both large industrial customers and small commercial/domestic customers.²⁴ The UK also has the lowest comparative prices in the EU at both the upstream and downstream levels.²⁵ The UK also has the strongest unbundling requirements of any EU Member State.²⁶

Access to the Transmission System

The way in which the NTS operates also contributes to promoting competition. Transco owns and runs the transmission system and is an independent company. There is non-discriminatory access to the NTS. The auction rules allow shippers to bid for entry capacity onto the Transco system on a short, medium or long-term basis. This allows shippers to book capacity in conjunction with developing new supply chains and the process also benefits Transco in its ability to plan expansions of the transmission system. This in turn allows for easier access to the market for new entrants and contributes to higher levels of competition.

Choice of Supplier

Finally, the UK system is characterised by the fact that consumers at all levels of the supply chain have real freedom of choice of gas supplier. This is an essential element of a competitive market.

In light of the above Dragon and the Throughputters do not agree that there is any need to regulate access or tariffs at the Facility.

4.3 Market Shares and the Current Level of Competitiveness

4.3.1 Upstream and Wholesale

The upstream gas supply market in the UK is characterised by a low level of concentration and a high degree of competitiveness. There are currently over 40 active suppliers and the largest single supplier is understood to have a market share of less than 16%. Various studies on the Herfindahl Hirschman Index (“HHI”), including both the BBL submission and the DTI’s November 2002 Response to Consultation of Gas Issues (URN 02/1306) all show an HHI of below 1000, indicating a very unconcentrated and therefore competitive market.

²² SEC (2003) 448.

²³ SEC (2003) 448 at 7.

²⁴ SEC (2003) 448 at Table 4.

²⁵ Ofgem, *Review of competition in non-domestic gas and electricity supply sectors: Initial findings*, July 2003 at paragraph 3.38.

²⁶ SEC (2003) 448 at 20.

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The relative positions of the Participants at the upstream level are not significant.

BG's market share is approximately 8%. [•]. Estimates of market share for the future are given in Confidential Annex 1. (This annex is confidential and not to be disclosed).

Petronas is not active in the UK gas supply market and therefore, if the sale of capacity to Petronas is finalised, it will become a new entrant in the UK market, thereby enhancing competition. Estimates of market share for the future, based on Petronas' market share in Dragon together with the earliest possible expansion are given in Confidential Annex 3.

As discussed above there are several elements to the wholesale level of the supply chain, including sales upstream or at the beach, sales at the NBP, the OCM market, the OTC market, the futures market run by the IPE, and other forums in which gas is, or could be, traded. As such, Dragon is of the view that there is not a single wholesale market. This makes it difficult to provide any meaningful analysis of the competitiveness of the wholesale segment, and there is no robust data on market shares in the wholesale segment. However, Dragon believes it can be assumed, given that traded volumes at the NBP far exceed physical volumes, that this is a liquid, competitive market. As noted by Gastransport Services in the BBL exemption application, activity at the wholesale level "covers not only physical transactions but also swaps, futures, options and other types of activity which are not necessarily physical in nature – such as transactions in which price risks are re-allocated between counterparties."²⁷

4.3.2 Downstream

The downstream segment includes all sales of gas to domestic users, industrial and commercial customers and power generators (excluding sales made directly to industrial and commercial and power generator customers at the wholesale level). Neither Petroplus nor Petronas are active in the downstream market at all.

BG's activities in the downstream sector are set out on page 4 and 5 of the Data Book. In terms of market shares, these are set out in Confidential Annex 2.

Domestic

The domestic market continues to be highly competitive. Despite market share being retained by Centrica (who, by way of reminder, has no connections with BG Group despite trading in the UK as "British Gas"), consumers can easily switch suppliers at short notice and there are numerous competing suppliers with increasing market shares. Further, the existence of the NBP and the large volumes of traded gas mean that the smaller retailers are not constrained in any way in respect of their gas suppliers. The addition of potentially 12 bcm gas to the UK market, intended to be by way of long and medium term contracts and shorter-term trades, will bring additional liquidity to the NBP and will benefit smaller suppliers. Even if some of the gas is sold to existing larger players, this will simply mean that correspondingly more gas will be available for trading at the NBP and will not be to the detriment of competing downstream players.

²⁷ Gastransport Services Draft application for an exemption for the Balgzand Bacton Pipeline project ("BBL"), Annex 4 at page 4.

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Competition is enhanced by ease of switching and availability of discounts. As Ofgem recently noted: “Healthy numbers of customers are switching, and express the intention to switch. Incumbent market shares continue to decline, although at a slower rate (largely as a result of more efficient incumbent win-back); around half of customers have compared prices, and 70% of these say it is easy; and those who have not yet switched supplier have access to a good range of discounts.”²⁸ Ofgem notes that 38% of domestic customers have now switched supplier and almost all of those who have not yet switched have access to cheaper offers: 12 competitors are offering discounts of up to 23% compared to British Gas [i.e. Centrica] to attract their business. Currently over 90,000 customers switch from British Gas [Centrica] each month.

It is important to note that the ease with which customers can switch suppliers, and the existence of a liquid traded market, prevents long term supply contracts with wholesalers or distributors foreclosing the market to other wholesalers and distributors. Customers may switch distributors resulting in the unused and therefore surplus volumes of the original distributor being resold in the wholesale market. This enables other competitors to satisfy their customers’ demand, or allows alternative sources of supply to meet customers’ needs.

Industrial and Commercial

The market share figures in BBL’s submissions show a very competitive segment, with 14 companies present and a HHI of 1179. We have not conducted a detailed analysis of this market but have no reason to suspect that BBL’s figures are inaccurate. As none of the participants are active in this segment we do not feel a more detailed analysis will be necessary.

Power Generators

BBL presented market shares (based on assumptions) in the BBL submissions which show a very competitive segment, with 11 companies present and a HHI of 1351 (the assumptions assumed the largest market share was Centrica’s, therefore leading to a higher HHI than would be the case had the authors had more detailed information).

Based on these figures, BG’s share of the power generator segment was stated at approximately 11%. This in itself would not give rise to any competition law concerns, but in any event BG believes this share to be considerably smaller (see Confidential Annex 2).

A recent publication by Ofgem shows only a moderate degree of concentration in the non-domestic gas supply market where the HHI is 1266.²⁹

Overall Downstream

²⁸ Ofgem, *Domestic gas and electricity supply competition: Recent developments*, June 2003.

²⁹ Ofgem, *Review of competition in non-domestic gas and electricity supply sectors: Initial findings*, July 2003 at Table 4.1.

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The market share figures in BBL's submission show the combined downstream HHI at 1359, with 21 companies active in the segment. These market share figures show that competition in the downstream segment is strong.

In addition, competition is further strengthened by the fact that rates of switching by all UK downstream customers, from large industrials to small commercial and domestic users, are the highest in Europe.

4.4 The Effect of this Project on Competition

The Project will enhance competition. It enables new sources of supply to enter the already competitive British market and contribute to the liquidity of the trading market. Further, it enables Petronas to enter the UK market as a new entrant in the upstream supply market, and assists BG Group to retain its position as a competitor to a number of larger suppliers.

As the Facility will constitute a new source of gas, the Throughputters will compete with other sources at the upstream level, resulting in more choice ultimately at the downstream, as well as alleviating potential price increases caused by supply shortages.

There is no creation or strengthening of any dominant position at any upstream or downstream level – Petroplus and Petronas are not active in the UK at the moment. Petronas' entry to the gas market can only enhance competition. BG's involvement in the project will help to maintain its existing market shares as supplies from existing North Sea gas fields deplete, but the Project is not expected itself to lead to any noticeable increase in BG Group's market share figures. In any event, the market shares of the participants, where Petroplus and Petronas currently have no share and BG's upstream share is no more than 8%, are clearly not at the level where competition law concerns could arise.

The wholesale market is already liquid. The Throughputters will sell their gas separately. BG plans to market the gas through a combination of long and medium term contracts, year ahead sales and spot sales. This will help to maintain the liquidity of the wholesale market and help to ensure that gas supplies continue to be available to all purchasers on the wholesale markets. Petronas has concluded a contract to sell its gas resulting from the initial phase of the project to Centrica. Although we are aware that this has raised concerns, particularly for the European Commission, Dragon remains of the view that, for the reasons set out above, the existence of the NBP and the high volumes of gas traded "at the NBP" means that even sales to larger downstream players such as Centrica will have no foreclosure effect and will not lead to any creation or strengthening of any dominant position on the downstream market. We understand that this is also Ofgem's current view.

The Throughputters will not impose resale restrictions or destination restrictions on the gas sold. This means that gas sold by the Throughputters may well itself be traded further at the NBP or even be re-exported to other EU Member States.

4.5 Competition in Narrower "Markets" - LNG Regasification Terminals

The Dragon participants believe that, as gas supplies compete with each other to find buyers, and LNG chains are just one of a number of ways of bringing gas to the market, it is not accurate to regard regasification capacity as a separate market.

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If such a market did exist, it would be at least EEA wide. Where LNG chains are being put in place LNG suppliers can select facilities from a number of geographical locations within the EEA. Once regasified and supplied into the national transmission systems, the gas can then be traded at the wholesale level across different contracting states using national distribution systems and interconnectors.

Annex 3 contains an updated version of the existing and potential LNG import/ regasification terminals³⁰, adjusted to show the Participants' views on Dragon and a correction on Brindisi. This shows that Dragon, even if both expansion options are exercised, will have no more than 6% of the potential LNG regasification capacity in the EEA.

Petronas' share of this market segment, assuming it exercises its expansion option, would be no higher than [0-5%].

To BG's [0 – 5%] market share needs to be added its interests in capacity in the Brindisi LNG Terminal of 3.2 bcma. This gives BG a maximum market share of [•].

Even if all other planned and potential terminals were excluded and the figures were calculated purely on the basis of Dragon's addition to the capacity at the 9 existing terminals, the initial capacity at Dragon of 6bcma would represent 11.5% of total EEA capacity of 52 bcma.

5. The Conditions for an Exemption in Article 22 of the Gas Directive and Section 19D Gas Act 1986 (as amended)

5.1 Condition A – The investment must enhance competition in gas supply and enhance security of supply

Competition

Please refer to the competition analysis in Section 4 above, which discusses how the investment will enhance competition in gas supply.

Security of Supply

As the Joint Energy Security of Supply Working Group ("JESS") recently stated in its third report, "in the next twenty years, as production from the UK Continental Shelf declines and the UK becomes more dependent on imported gas, there will be an increasing need for new gas supply sources as well as investment in infrastructure projects to meet both annual demand and the seasonal and daily swings in demand."³¹ The report lists LNG imports as one of these new gas supply sources, in addition to imports from Norway and imports from Europe via interconnector.

It is clear that as UK production declines, projects such as the Facility will play an important role in enhancing security of supply. If the project goes ahead and Throughput Agreements

³⁰ reproduced with updates from Annex 16 of the Exxon Mobil submission

³¹ Joint Energy Security of Supply Working Group (JESS), *Third Report*, November 2003 at paragraph 35.

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are finalised in time, it will be a guaranteed method of additional gas supply to the UK for the term of the Throughput Agreements.

It can be noted here that potential LNG supplies are currently in wide demand throughout the developed world to meet expected shortfalls in existing supplies not only within the UK but also the rest of the EU, the US and elsewhere. In other words, although there are various potential LNG sources, these will not necessarily be available for importation into the UK (or, via the interconnectors, the rest of the EU) unless the regulatory regime is sufficiently favourable. For example, if LNG supplies find a more favourable regime in the USA, it is possible that some of the new upstream LNG projects currently being contemplated could be modified or abandoned to take LNG to the USA instead. This would undermine the security of future UK (and EU) gas supply.

5.2 Condition B – The level of risk attached to the investment is such that the investment would not take place or would not have taken place unless an exemption is granted

In their discussions with Petroplus, both BG and Petronas and potential lenders have said that a clear and favourable resolution of what they see as the current regulatory uncertainty is a condition of their participation in the project. Dragon believes that the project will not proceed unless the exemption requested in this application is granted. Specifically, the exemption must cover the period of the Throughput Agreements, and must cover 100% capacity, including the expansion options.

5.2.1 The Duration of the Exemption

Dragon requests that, in respect of both the initial capacity and the future expansions, the duration of the exemption is 20 years from the start of initial operations of each. This is the minimum sufficient to allow a 20 year Throughput Agreement to be put in place in respect of the initial and additional capacity.

A shorter exemption period will prejudice the possibility of securing LNG supplies and obtaining financing as envisaged.

Precedent supports the duration of the exemption requested

European law precedents support the granting of an exemption for periods in excess of 20 years, the period being requested by Dragon. In its initial comments on the South Hook application, Ofgem states that it has no objection to giving long-term exemptions and it notes that this is consistent with European Commission rulings with respect to other projects, especially the UK-Belgium gas interconnector, for which a 25-year exemption was granted.³²

More recently the European Commission has found that agreements for the construction and operation of the new Viking sub-sea cable between Norway and Germany for transmission of high-voltage electricity and including a 25-year exclusivity period were not contrary to

³² Ofgem, *Qatar Petroleum and ExxonMobil Draft application for a Gas Directive exemption for a proposed LNG terminal at Milford Haven: Initial views*, December 2003. This view continues to prevail in the recently launched 13 October 2004 consultation on the South Hook formal application, as Ofgem has indicated that it intends to grant an exemption for 25 years for each phase of that project

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Articles 81 or 82.³³ On the duration of the agreements, the Commission observed that “[t]he construction and operation of sub-sea cables covering long distances in deep waters is very capital intensive. The Power Agreements must therefore be long-term to ensure investment. To secure the viability of the investment in transmission capacity via the new cable, the notifying parties [deem] that it is necessary to have long-term arrangements[s] over the same lifespan as a normal power plant, *i.e.*, approximately 25 years.”

In addition, in a case concerning a joint venture for the operation of night trains between the UK and the Continent via the Channel Tunnel, the Court of First Instance has stated that it “considers that the duration of an exemption granted under Article[81](3) ... must be sufficient to enable the beneficiaries to achieve the benefits justifying such an exemption Since, moreover, such progress and benefits cannot be achieved without considerable investment, the length of time required to ensure a proper return on that investment is necessarily an essential factor to be taken into account when determining the duration of an exemption, particularly in a case such as the present, where it is undisputed that the services in question are completely new, involve major investments and substantial financial risks and require the pooling of know-how by the participating undertakings.”³⁴

European law precedent and Ofgem’s own approach support Dragon’s position of seeking a 20-year exemption. Further, given that this project will enhance competition and security of supply, we consider that Ofgem cannot have any reason to suggest that the duration of the exemption should be shorter than requested. The Commission’s Comfort Letter also accepts that the duration is appropriate.

A minimum 20-year exemption is required for the project to go ahead

Considering the degree of risk involved in pursuing this project and the extent of the investment and financing needed both for this project and for the other parts of the LNG chain, Dragon considers that an exemption of at least 20 years duration is required.

Also Throughputters need longer contracts as these will be favoured by LNG suppliers in order to achieve the necessary security they require before they are able to commit to upstream investments. Throughputters cannot invest to put an effective LNG supply chain into operation unless they have the security of having capacity at the regasification stage for a longer period.

A shorter exemption period has negative implications for the tariffs in the Facility, with upward pressure on prices for LNG supplied through the Facility. If the exemption is for a shorter period, the Throughput Agreements will need to be reduced. The tenor of the debt may also need to be reduced to ensure an adequate “tail” is available at the end of the financing period. A shorter debt tenor will imply higher annual debt service and hence either an increase of throughput tariff (thus rendering gas supplied through the Facility less competitive than alternative sources), or a reduction in the amount of debt available. The increased requirement for project equity funding that would result would be highly unattractive to developers and might prejudice the viability of the project for them.

³³ Viking Cable, (Notice pursuant to Article 19(3) of Regulation 17) [2001] OJ C247/11.

³⁴ Joined cases T-374-5, 384 and 388-94, *European Night Services Ltd (ENS) v. Eurostar* [1998] ECR II-3141, judgment of 15 September 1998 at paragraph 230.

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A review of the exemption after an interim period (e.g. 10 years) would have the same impact at this stage as granting a shorter exemption due to the uncertainty it would create – the Throughputters and lenders would have to assume a “worst case scenario”, that the exemption would be withdrawn or significantly altered after 10 years. This would not only impair financing, but, more importantly and crucially, would prevent the Throughputters from securing long-term LNG supply contracts, given the need for LNG suppliers to have a long-term offtake of their LNG in order to finance the upstream arrangements.

5.2.2 The expansion option

As described in Section 2.2, when negotiating with Dragon during the open season process, both BG and Petronas expressed interest in an initial 3 bcma each of capacity, with a further [•]each of expansion capacity. For this reason Dragon decided to grant expansion options to the Throughputters in order to provide a further incentive for them to enter into the Throughput Agreements. BG and Petronas therefore view the expansion options granted them as an integral part of their agreements with Dragon, and require the same level of regulatory certainty, including exemptions under the Second Gas Directive.

Certainty of capacity rights in an expansion is required to enable the Throughputters to build an LNG supply chain for the expansion capacity. As noted in Section 2.1.5 above the large fixed costs in developing an LNG supply chain mean that economies of scale are essential to ensure competitiveness and profitability. However the need to manage market risk (for example the ability of a market to absorb large new volumes of gas supply), mean that it may not be feasible to achieve the economies of scale from the start. For this reason it is common for both LNG suppliers and LNG importers to have a phased approach to the build up of LNG volumes.

In addition there is the requirement to synchronise construction of re-gasification capacity with the availability of new sources of LNG supply. The Throughputters believe that there are a number of sources of LNG supply which will only become available after the first phase of the Facility is in operation.

If the expansion option capacity is not exempted and Dragon finds itself in that case unable to offer a binding option to the Throughputters, the attractiveness of the initial capacity will also be severely diminished; Dragon does not believe that alternative throughputters can be found in the time available to ensure the project is constructed in time for the 2007 start-up period. As explained in section 3.2, this itself means that the Facility may not be built at all.

The expansion options do not prevent Dragon from selling expansion capacity to third parties so long as this does not undermine the expansion options granted to BG and Petroplus. In such a case the sale of expansion capacity to third parties would be subject to the planning and physical constraints of the site. Dragon would also need to ensure that the operational difficulties of running a multi-shipper terminal could be properly managed so that Dragon could continue to meet contractual commitments to the existing Throughputters.

5.2.3 The Exemption must cover 100% of the Capacity

The participants require the exemption to be granted for all of the capacity at the Facility, for the reasons set out in Section 3.2 above.

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5.3 Condition 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 interconnector will be built

Dragon is to be the owner of the Facility. Dragon is a limited liability company, incorporated under UK Law and as such is a legal person separate in legal form from the current system operator, Transco. Dragon's shareholders will themselves be completely unconnected with Transco. This is clearly recognised by both Ofgem and the European Commission.

5.4 Condition D – Charges are levied on users of that infrastructure

Dragon will operate on the basis of a market-based throughput fee charged as a tariff per therm throughput. A detailed charging regime will be set out in the Throughput Agreements.

5.5 Condition E – The exemption is not to the detriment of competition or the effective functioning of the internal gas market, or the efficient functioning of the regulated system to which the infrastructure is connected

Not a detriment to competition or the effective functioning of the internal gas market

Please refer to the competition analysis in Section 4 above, which discusses how the exemption will not be to the detriment of competition or the effective functioning of the internal gas market.

Dragon believes that the entry of a new competitor, Petronas, and the availability of new sources of supply into the UK market will, in fact, enhance competition, and that this is the case even if a proportion of the gas is sold to Centrica.

Efficient functioning of the regulated system to which the infrastructure is connected

Dragon will enter into a Network Entry Agreement with Transco, which governs the technical and safety issues in respect of the connection of the Facility to the NTS and will comply with the rules thereunder.

An entry point at Milford Haven is further expected to help better balance the NTS.

5.6 Condition F – the Commission of the European Communities is or will be content with the exemption

The outcome of the Informal Exemption Request process is that the sponsors believe the exemption to be fully satisfactory to the European Commission, as set out in the Commission Comfort Letter.

6. Specific Issues Raised by Ofgem

6.1 *Anti-hoarding Mechanisms and UIOLI*

In order to secure financing for the terminal, Dragon will sign long term Throughput Agreements with the Throughputters which will require the Throughputters to pay fixed charges irrespective of use of the terminal. Throughputters will therefore have a high incentive to maximise use of the terminal.

Dragon's intention is to operate the Terminal on a base load basis with each of the two initial Throughputters having access to 50% of the initial capacity of 6 bcma. This represents the guaranteed annual nameplate capacity of the Terminal.

The Throughput Agreements will enable secondary trading of capacity between the Throughputters in the event that a Throughputter does not use its full capacity entitlement.

In the event that neither Throughputter wishes to use capacity, Dragon will make this capacity available to third parties. The process for this is detailed further in Annex 5.

6.2 *Provision of Information*

The terminal will provide Ofgem with nominated and actual capacity utilisation of the Terminal on a monthly basis, and other such information as Ofgem reasonably requests to fulfil its functions.

Dragon notes the ongoing discussions regarding transparency of information in the UK gas industry. Dragon is concerned that any requirements that may come into force to publish information to the market should not prejudice the commercial positions of its customers, the Throughputters. (For example, where publication of information would identify the nominated and actual capacity utilisation of individual Throughputters). Recently agreement has been reached between gas producers, Transco, OFGEM and the DTI concerning the publication of information relating to flows onto the national transmission system from beach terminals and forecast deliverability. Such information is to be published on an aggregated basis to avoid individual companies' positions at terminals being identified. As Dragon remains concerned that any requirements to publish information should not prejudice the commercial positions of its customers, we would expect any requirements to publish information in relation to the Facility to be consistent with the level of detail required to be published in relation to other terminals.

7. Specific Issues Raised by European Commission

Response to Questions Forwarded by the European Commission during the Informal Exemption Application Process with Respect to Dragon's Application for an Art. 22 Gas Directive Exemption for its UK LNG facilities

A) Development of the Project

1. Which main contracts were signed until today as regards the UK LNG project (including heads of agreements). To the extent necessary for the understanding of the project also provide copies of other contracts, e.g. relating to the gas field, liquefaction plant, LNG ships, sale of gas in the UK. Please provide a copy of these agreements. Which contracts will be signed in the coming months.

Binding contracts for the sale of the capacity have not yet been signed. Following the conclusion of the "Open Season" Dragon signed a Memorandum of Understanding with BG Group on 12 November 2003 to sell 50% of the capacity. A Letter of Intent was signed with Petronas on 17 December 2003 and a Heads of Agreement was signed on 5th March 2004. Definitive agreements for the sale of the capacity will be concluded as soon as comfort is received from OFGEM and the European Commission that the Facility will be exempted from the regulated access provisions of the Gas Directive. Timing therefore depends on the speed with which such comfort can be obtained, but agreements are targeted to be signed no later than [•] in order to meet project deadlines.

It is planned that contracts for the design, procurement, construction and commissioning of the terminal will be signed at the same time as the contracts for the sale of the capacity, following the conclusion of the competitive tendering process currently being conducted.

Contracts for the purchase of LNG supplies can really only be finalised once the sellers are satisfied that the buyers have purchased or otherwise secured sufficient regasification and shipping capacity to be able to receive the LNG as and when it is produced. Unlike the Qatargas / Exxon-Mobil project of which Ofgem and the Commission may be aware, this project is being implemented as a new competing source of gas into the United Kingdom, rather than as a mechanism for monetising identified upstream production. It is therefore not possible to give information about contracts relating to the gas field or liquefaction plant as the supplying source of LNG has not yet been identified. BG and Petronas are currently in negotiations with [•] LNG suppliers, both internal and third parties, and would ideally seek to have long-term LNG supply arrangements in place at the same time as the signing of the capacity contracts. Whichever LNG supply arrangements are put in place, it is likely that the LNG supplier will also be looking to conclude a long-term contract to underwrite the investment in the upstream fields and facilities.

Gas sales agreements

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Petronas does not produce or sell gas currently in the UK and has no downstream contracts in the UK. Under the current plans, based upon the Dragon LNG terminal becoming operational, Petronas intends to sell the LNG regasified at the Facility using its throughput capacity into the UK market.

*In the UK, BG, in common with other producers and suppliers, no longer links gas sales contracts into any particular facility, gas field or other supply source. In the past (as in the **Britannia** case referred to by the Commission (OJ C 291/10), contracts may have been “dedicated” to particular fields, which enabled producers to pass volume risks onto customers and obtain legal certainty to develop the field in question in exchange for a long-term exclusive offtake contract. Given the wide variety of sources of supply in the UK market today, domestic, industrial and commercial customers are unwilling to enter into long term contracts with any particular supplier, and most customers are usually not prepared to accept volume risk. In other words, contracts, whether on a medium or short term, would be concluded for fixed volumes (subject to the ability negotiated by customers in some contracts to vary offtake). From BG’s perspective this means that gas imported into the UK via the Facility will simply form part of BG’s gas portfolio, to be marketed or sold under contract together with BG’s other gas. BG’s marketing plans are revised from time to time, and, once the capacity, shipping and long-term LNG supply is secured, BG will be able to factor the resulting gas into its marketing plans. It can be said, however, that the gas which is being brought into the UK via the Facility is not required to make up any shortfalls under existing long term sales contracts. It can therefore be said with some certainty that all 3bcma will be offered to the market at the NBP to buyers who will be able to use or resell the gas without restriction.*

Shipping Contracts

The number of ships required to support the LNG chain will depend to a large extent on the source of the LNG, as this impacts the timing of the shipping cycle (days needed to transport LNG, time spent unloading at the jetty, days spent returning to the LNG source and days spent loading LNG). However, if a Throughputter is successful in securing an LNG supply not more than 1500 miles from the Facility and wishes to use this to build a 3bcma chain, then that Throughputter will probably require 2 LNG tankers to operate the chain, at a cost of \$150 million each.

BG has [•] new build vessels on order to support other existing projects and options to acquire an additional [•] new build vessels. Once the LNG supply contracts are finalised BG will be in a position to determine its requirements for additional ships. It seems clear, however, that [•] additional ships will need to be purchased to support the LNG chain to be created into the Facility.

Petronas intends to utilise the shipping fleet of Malaysian International Shipping Corp.(MISC) (in which Petronas is a majority owner).

2. In which stage of development are the various facilities to implement the project (production facilities, gas treating and liquefaction facilities, LNG ships, LNG regasification facilities) and when do you expect them to be fully operational.

The initial stage (6bcma) of the regasification facility is expected to become operational in [•] 2007.

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3. Which board approvals were already obtained for the project (please provide copies of these documents). To the extent necessary for the understanding of the project also explain which board approvals were already obtained as regards the gas field, liquefaction plant, LNG ships, and sale of the gas in the UK. When do you expect these approvals.
 - *Approvals for BG and Petronas to enter into a long-term capacity purchase contract and to take equity in Dragon are expected to be obtained in [•].*
 - *Approvals for Dragon to enter the respective long-term capacity sales contracts are expected [•]*
 - *Approvals for Petroplus to sell some of its equity in Dragon to BG and Petronas are expected [•]*
4. Please indicate – to the extent known – the state of play of “competing LNG projects” for the UK market. To the best of your knowledge: Did they carry out an open season prior to initiating their project or did they reserve a certain percentage of the capacity for third parties?

We would refer you to the table on page 7 of the November 2003 Wood MacKenzie report on “The Timing of Gas Import Infrastructure to the UK”. Other than the Dragon facility this shows “the Exxon-Mobil 18bcm facility” and “the Isle of Grain Transco 3.6 bcm facility”, as well as the Zeebrugge LNG 2-3bcm expansion. We would point out, however, that “competing projects” include not only LNG projects but all other projects for bringing gas to the UK, including new pipeline projects.

As you know, Dragon did conduct an “open season” for the sale of all the capacity in the Facility, as a result of which it intends to sell 100% capacity on a long-term basis. We are aware that the Exxon Mobil Milford Haven, being an “own use” project, did not conduct an open season, but other than that we have no information beyond what is given in the Exxon-Mobil Informal Application for Exemption dated 26 November 2003, as published on Ofgem’s website.

B) Market definition

5. What would be the market share of Petroplus on the market “supply of gas by producers to European wholesalers” in 2007 and thereafter taking into account the so called “forward market” defined in the Britannia case³⁵, i.e. the supply gap not covered by long term contracts that needs to be filled. *See general comment on market definition in footnote below*³⁶

³⁵ OJ 1996 C291/10, recital 5.

³⁶ The figures given here are based on our understanding of the market definition given in the Britannia case, i.e “the future supply of natural gas by producers to the wholesale level (forward gas)”. With respect, we believe that market liberalisation means that this is no longer the same as “the supply gap not covered by long term contracts that needs to be filled” (although it may have been at the time of the Britannia case): If demand in a year’s time is likely to be 100 units but 40 units have already been forward sold by producer X, then X has already achieved 40% market share, not 0. If two other producers each sell 30 units then they will each have 30% market share, not 50% . This is backed up by the fact that, at the end user level, domestic customers in the UK are free to switch suppliers at any time and commercial users are currently unwilling to enter into long-term contracts. This means that, even where a long-term contract is in place with a wholesaler or distributor, the volumes represented by that

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Petroplus is not involved in the gas market other than as the developer of the Dragon facility. Dragon will be selling regasification services to the Throughputters, but neither Dragon nor Petroplus will themselves have any market share on the market identified.

Given that Dragon will effectively be selling 100% capacity to third parties and has already conducted an open season to identify those third parties, the market share of the Throughputters should not be of concern. However, as the Throughputters will also be acquiring equity in Dragon, meaning that the terminal, once it is operating, may be said to resemble an “own use” terminal, we are pleased to provide details of the Throughputters’ market shares for the sake of completeness and in order to show that, even if the market share of the Throughputters is relevant, it should still not give rise to any substantive concerns whatsoever.

BG *see Confidential Annex 1*

Petronas *see Confidential Annex 3*

6. What would be the market share of Petroplus on the market “supply of gas by producers to British wholesalers” in 2007 and thereafter taking into account the above mentioned model.

Petroplus is not involved in the gas market other than as the developer of the Dragon facility. Dragon will be selling regasification services to the Throughputters, but will not have any market share of the market identified. Figures for the Throughputters are given for the sake of completeness:

BG *see Confidential Annex 1 .*

Petronas *see Confidential Annex 3*

7. To the best of your knowledge: what are other incumbent suppliers in the UK market currently doing to fill the supply gap forecasted for the UK in the coming years.

Our information on this is derived from publicly available sources, such as the Morgan Stanley report published 14 November 2003 “Gas Imports Fill UK Gas Gap without price crunch”. This shows that a large variety of projects are currently being considered to bring additional gas supplies to the UK. In addition to the LNG terminals already mentioned, there is the Gasunie BBG pipeline, the Ormen Lange development and associated pipeline,

contract are in no way foreclosed to other producers, as it is not certain that the demand in question will be met by that contract - the end-users may switch distributors, resulting in the unused volumes being resold on the wholesale market by the distributor who now has surplus gas, or resulting in other producers being able to sell production into the market even where the demand was originally expected to be filled by an existing contract. Please also note that the figures given relate to physical volumes rather than sales and resales as we have not taken account of “traded volumes”. Consistent with OFGEM’s comments in para 2.31 of their “Initial Views” document of December 2003 on the ExxonMobil draft exemption application, BG does not believe it is useful to look at share of traded volumes, given that the NBP trades approximately 13 times the physical volumes through the National Transmission System.

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expansions to the UK-Belgium interconnector to expand the reverse flow, and the use of existing pipelines to import gas from Norway. Indeed, Wood MacKenzie estimate in their report "The Timing of Gas Import Infrastructure to the UK" that, if all planned projects are realised, new capacity in excess of 100 bcm per annum would be created.

The UK market cannot support such a large increase in capacity. This means that only projects which can be sanctioned quickly are likely to be built, as "latecomers" are likely to lose their credibility and become less attractive to financiers once it is known that the supply gap is being met by other means. This is another reason why legal comfort for Dragon is required as soon as possible. If delays occur in achieving project sanction then Dragon may no longer be in a position to achieve operational start-up in 2007, and such delays will threaten the viability of the project as a whole.

C) Risk Assessment

8. Please explain all risks associated with the project. Distinguish between technical, commercial, legal/regulatory, political risks.

Technical and operational (legal) risk:

Although LNG is a proven technology and no new technology needs to be developed, the nature of an LNG chain, and its cost effectiveness, depends on being able to make optimal use of the facilities. Given the high cost of the equipment, it is not cost effective to build in spare plant or 'redundancy'. Operational efficiency is therefore paramount - delays arising at the Facility can have significant legal and commercial consequences further upstream and downstream if the Throughputters are faced with obligations to purchase LNG upstream and supply downstream but are experiencing bottlenecks at the Facility.

Commercial Risk - Timing

A significant risk to the project is the timing issue outlined in the answer to Question 7 above. Unless project sanction is obtained in [•], financiers, LNG suppliers and gas customers may start to question the ability of the project to be operational by 2007, a key date in terms of meeting the supply gap in expected UK demand. If, at any stage, the project loses credibility, gas producers, LNG suppliers and their financiers, and gas customers are likely to turn to competing projects and are more likely to enter into the necessary contractual arrangements in relation to such projects, leading to alternative projects being developed instead of Dragon's Facility.

Commercial Risk – Demand for Regasification Capacity

There are a large number of potential alternatives to the Dragon Facility for bringing gas to the UK. Even once the terminal has been built, the risk remains that other supply options become more attractive or more cost effective. For example, if the question of third party access to Russian infrastructure is resolved, large quantities of gas from Iran, Azerbaijan or Kazakhstan could be brought by pipeline into the EU. Such a project would make LNG less attractive and, in the absence of long term contracts to sell capacity in the terminal, Dragon could be faced with an unwanted terminal. The same threat also exists from the volumes which may be piped to the UK from Norway, or via new or existing interconnectors. Indeed, demand for regasification capacity will always depend on the competitiveness of LNG

compared to other sources of gas. This issue is made more acute by the fact that the regasification tariffs charged by Dragon will always constitute a minor part of the costs of bringing LNG to the UK, given the large investments required in other parts of the LNG chain. Even if Dragon were compelled by market conditions or regulation to reduce its tariffs to something approaching marginal cost, this would of itself not be sufficient to ensure that demand for capacity would exist if conditions in the wider gas market or infrastructure access had shifted demand away from LNG.

Regulatory Risk

The need to enter into contractually binding long-term arrangements in order to underwrite investment, to mitigate against the risk of unsold capacity and to commence construction of the Facility means persuading LNG suppliers and financiers of the viability of the project on a long-term basis. Dragon itself needs to ensure that the arrangements currently being discussed with the Throughputters can be implemented as quickly as possible.

9. Please explain which of these risks justify your request for exemption and why.

a) **Financing:** *We understand from discussions with our financial advisors that financiers will not take account of any potential revenues which are not secured by binding contracts in place by the time of financial closing. Until a regulated third party access regime is established it will not be possible to sell regulated capacity, as the terms of such capacity will be unknown. It is therefore unlikely to be possible to sell regulated capacity in advance of planned financial closing. Lenders will not take into account revenues which are not underpinned by long term Throughput Agreements. Dragon will therefore have to underwrite investment in any regulated capacity itself. This will lead to either Dragon charging higher tariffs to Throughputters to meet shareholders rate of return expectations and thus rendering imported LNG less competitive, or the shareholders accepting a lower rate of return, making the project less attractive and less likely to go ahead. Dragon does not believe either alternative will prove acceptable either to Petroplus, or to the new proposed shareholders, or to BG and Petronas as Throughputters.*

b) **Delays pending adoption of regulatory regime:** *Even if Dragon were permitted to sell a proportion of capacity to the Throughputters (the Commission has asked us to consider a possible hypothesis of 80%) and the remainder on a regulated basis, Dragon would not be able to conclude contracts for the remaining 20% until the applicable regulatory regime had been finalised. As shown above, given that the sponsors are not prepared to change their financing plans for the Facility, this will delay the closing of the financial arrangements and means that the Facility will not be in a position to be operational by 2007. This in turn affects the attractiveness of the Facility given the large number of competing infrastructure projects, and leads to an increased risk that Throughputters may no longer be in a position, once the regulatory regime is finalised, to enter into long-term Throughput Agreements.*

c) **Market Risk:** *Unless Dragon enters into long-term Throughput Agreements in the near future, there is a risk that overall market conditions mean that demand for regasification capacity may turn out not to be sustained and planned capacity in the Facility may remain unsold. This is not only an unacceptable risk for financiers, but also an unacceptable risk for Dragon and its shareholders.*

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Dragon therefore needs to lay off this risk by entering into contracts for all the capacity with Throughputters. In doing so all risks relating to securing LNG supplies, selling resulting gas and managing the shipping capacity and other elements of the LNG chain can be passed on.

In order to enter into such contracts and lay off the risk, Dragon needs to offer the Throughputters a level of comfort that capacity can be lawfully allocated to those Throughputters and that the contracts for the sale of the capacity will be legally binding over their term on the terms and conditions (including tariffs) agreed. Although Dragon held an Open Season and the Throughputters had to bid for capacity, the Throughputters cannot be certain, in the absence of an exemption, that Dragon is truly in a position to be able to sell the capacity to them as envisaged. This in turn has wider ramifications in other parts of the LNG chain. The Throughputters, in seeking to secure LNG supplies, need to be able to persuade LNG suppliers that they will have readily available capacity at the appropriate time and that they have secured a market for the regasified LNG³⁷

The economics of the LNG suppliers are such that they, too, need to put in place long-term contracts to underwrite their investments. For this reason the LNG suppliers (including the interests owned by local governmental agencies), their financiers and the applicable local ministries will all need to be convinced that the Throughputters have certain and legally enforceable rights on agreed terms to the capacity in question.

d) Operational Issues: *A similar risk is that a multiplicity of Throughputters will lead to operational issues and scheduling delays, which could make it impossible for the primary Throughputters to fulfil their own contracts. For this reason Dragon suspects that the primary Throughputters identified in the Open Season may have serious reservations about using the Facility in conjunction with other throughputters (as might be the case if any part of the capacity were subject to a new open season) and this might jeopardise current negotiations.*

Dragon believes it should therefore be clear that the above is only achievable if a full 100% of capacity exemption is granted for the Facility. Any suggestion that even part of the Facility needs to be regulated will place the Throughputters in a difficult position in their negotiations with LNG suppliers, and the risk of additional shippers being allowed to use the Facility will make the Facility less attractive to the Throughputters from an operational and scheduling perspective. This is equally the case in respect of the expansion capacity, as otherwise neither the terminal owners, nor the Throughputters or their financiers will be able to obtain the necessary certainty as to how the terminal will work operationally.

In addition, the timing issues mentioned above mean that, were Dragon obliged to offer less capacity to the potential Throughputters on a firm basis, or if Dragon were compelled to conduct a new open season in order to offer capacity to the Throughputters, Dragon cannot be certain that the Throughputters will be in a position to conclude contracts on that basis

³⁷ On this point it is important to note that, although the Throughputters may have an interest in certain upstream LNG projects, neither of them is in a position in those projects to determine the destination of those LNG supplies or to decide where to source LNG, as they must respect the interests of third party joint venture partners and/or the wishes of the appropriate government. In other words, the proposed Throughputters cannot be certain that they will secure LNG supplies from any particular source until contractual arrangements are negotiated with the LNG suppliers.

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prior to [•], with the result that the viability of the project as a whole would be called into question.

10. Please outline the investment costs from the beginning of the UK LNG project until the expected end. Distinguish between the following cost factors: a) erection of the facility, b) operation and maintenance of the facility, c) capital costs, d) other (please specify). Which part of the operation and maintenance costs can be attributed to quality conversion, if necessary. For the purpose of this question, distinguish between phase one and two. Please use table below (for phase one and two separately).

Please see financial models in Annex 4

11. Please outline the expected revenue flows for the same period.

Please see financial models in Annex 4

12. Please explain how the UK LNG project will be financed and if it is financed by third parties during which period is full reimbursement foreseen.

The basis of the understanding between the Participants, and the basis of current negotiations between them, is that the development be financed under a project finance (i.e. limited recourse) basis by third party lenders. The Participants are currently considering various financing markets in which to execute the financing, such as project finance banks, capital markets and other long term finance providers. The current assumption for the reimbursement period is [•] years from execution of the financing, targeted for [•] depending on other conditions such as regulatory exemption being met. Lenders expect a "tail" after the reimbursement period to allow for recovery of any project debt shortfalls towards the end of the debt life. Such a "tail" could be expected to be between [•]. On this basis a [•] reimbursement period (which would start from financial close) with [•] tail would only be possible if there were 20 year Throughput Agreements starting 3 years after financial close. The Throughput Agreements would in turn be dependent on an exemption of the appropriate duration.

13. If possible please present a discounted cash flow investment analysis for the UK LNG project. Please explain when you expect break even for the UK LNG project and for the overall project.

Please see financial models in Annex 4

14. Please provide copies of all business plans linked to the UK LNG project and to the extent necessary also for the remaining parts of the project (gas field, liquefaction, LNG ships etc.).

As explained above, as the LNG chain has not yet been put together it is not possible to provide details of the other parts of the project. In any event Dragon is only involved in the regasification terminal, not in the other parts of the project which are being managed by the Throughputters.

15. Please provide copies of all documents submitted to board approval and minutes of the board meetings deciding upon the matter (UK LNG project as well as – to the extent necessary the overall project).

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16. Highlight in the submitted copies all explanations related to the risk assessment of the project (UK LNG project as well as – to the extent necessary – the overall project).

17. Please explain any open season process that was undertaken concerning this project.

Please see Section 2.2 and Annex 2.

18. Please explain to what extent any capacity can be made available to third parties under normal regulated TPA regime as set out in the new gas Directive.

No capacity can be made available under “normal regulated TPA regime”, for the following reasons:

- *Financiers will not take account of any capacity not sold under contract. This affects the financing costs and does not comply with the model envisaged by Dragon and being discussed with the potential Throughputters.*
- *In order to sell capacity, purchasers need to know that the capacity is being lawfully allocated to them and that the terms and conditions of the applicable contract are fixed for the life of the contract. If Dragon has to wait for the applicable regulatory regime to be finalised before offering such capacity, this will delay project sanction beyond [•] and means that the Facility will not be operational by [•] 2007. In turn this means that other solutions to address the UK supply gap may have progressed to the stage that regasification capacity at Dragon is no longer required or no longer as commercially attractive, and Dragon risks being unable to sell the capacity.*
- *In addition, there is a risk that the current proposed Throughputters, chosen following an open season, may not be willing to enter into contracts for capacity if this is to be dependent upon sharing with other unknown shippers. This is due both to the risk of operational difficulties if there are many shippers and because the Throughputters cannot be certain that that capacity will be available in the timescales required unless project sanction is achieved in the near future. In other words, Dragon cannot be certain to be able to sell any capacity (not just the regulated capacity) in the timescales envisaged unless a full exemption is granted in the near future.*

In any event it is Dragon’s view that no capacity in the Facility need be offered under the “normal regulated TPA regime”, as the criteria for exemption under Article 22 of the new Gas Directive are all fulfilled.

19. Please explain the duration of the exemption sought. What will happen after the expiry this time?

Given the competitive nature of the gas market in the UK, Dragon believes it should be possible to grant a permanent exemption for the Facility. However, at a minimum exemption is needed for 20 years from when the terminal becomes operational, which is 2007 in respect of the initial capacity and a few years later (probably 2009 and 2012) in respect of the expansions.

A 20 year exemption is required for a number of reasons. Firstly, as shown, Dragon wishes to pass risks on to the Throughputters, particularly as regards demand for LNG

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regasification capacity. The Throughputters themselves need long-term contracts in order to put in place other arrangement in the LNG chain, including LNG supplies and shipping.

Long term Throughput Agreements are also required from a financing perspective. Lenders will not take into account revenues which are not underpinned by long term Throughput Agreements. Lenders also require a “tail” of a few years at the end of the debt reimbursement period to allow for the recovery of any debt shortfalls at the end of the debt life. Throughput Agreements therefore need to cover the reimbursement period and the “tail”. If this does not happen, for example where Throughput Agreements are of shorter duration due to a shorter exemption period, there are a number of alternatives, none of which are attractive to project sponsors and / or throughputters.

A shorter debt tenor implies a higher annual debt service which would require either a higher throughput tariff or would allow the project to raise less debt. The former would render LNG imported via Dragon less competitive, and hence Dragon would be less attractive to Throughputters. The latter would require the shareholders to inject more equity which would be highly unattractive to developers and might prejudice the viability of the project for them.

Once the initial long-term LNG supply contracts expire Dragon would in all likelihood continue to want to sell capacity in order to maximise the returns from the Facility, which will have a working life of at least 50 years. The way in which such capacity would be sold would depend on market conditions at the time and of course would also depend on any applicable regulatory regime.

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Annex 1: SITE PLAN

See separate attachment

Annex 2 OPEN SEASON PROCESS

Document 1:

Text of Morgan Stanley Solicitation Letter

[?] Date

Address

[] []

Dear [?],

Further to your recent conversations with Petroplus Tankstorage International B.V. (“Petroplus”) in relation to the construction of a new LNG Facility at Milford Haven (the “Facility”), this letter and attachments solicit the interest of [] [] to enter into a long-term agreement (a “Throughput Agreement”) with the company, to be known as Dragon LNG Limited (the “Operator”), that will develop the Facility. The Throughput Agreement will be structured as a sale of service capacity and will oblige the Operator to receive LNG in quantities up to a contractual annual maximum, store it, regasify it, and deliver it as pipeline gas into the National Transmission System. The Operator expects to execute Throughput Agreements with between one and three Customers.

Your attention is drawn to the legal disclaimers in Appendix III to this letter.

The Solicitation Process

Morgan Stanley has been retained by Petroplus to solicit the interest of a number of qualified parties, being suppliers of LNG, marketers of natural gas, or integrated companies to enter into Throughput Agreements with the Operator.

The Commercial Framework for the development of the Facility and the negotiation of Throughput Agreements is set out in Appendix I.

A proposed Term Sheet for the Throughput Agreement is set out in Appendix II.

In addition, we are forwarding to you a supplementary package of technical information.

This solicitation also requests your expression of interest, if any, in the purchase of an equity stake in Dragon LNG Limited. Petroplus does not require such a purchase as a condition of participation in a Throughput Agreement, nor will unwillingness to purchase equity necessarily disadvantage a potential Customer.

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If your company is interested in entering into a Throughput Agreement with the Operator, we would ask you to express such interest in the manner set out below under “Expression of Interest”.

Indicative Throughput and Capacity Charge

Petroplus intends that the Operator will enter into Throughput Agreement(s) for the total annual gas throughput capacity of the Facility of 6 bcm, with provisions for daily and hourly peaking at higher rates. Petroplus expects that on this volume basis the cost of the service will be expressed as a Capacity Charge estimated to be [?] pence per therm of gas and a Variable Charge, estimated to be [?] pence per therm of gas, with an Operator’s Fuel Gas Allowance of [?]. Further details in relation to pricing are set out in Appendix 1 to the Term Sheet.

Expression of Interest

You are asked to submit your company’s Expression of Interest in entering into a Throughput Agreement with the Operator, either in original or by fax, not later than 12.00 pm (noon) (London time) on [Date], to Ms Melanie Chen of Morgan Stanley at the address stated in Appendix IV, setting out all of the information described below.

- Your acceptance of the commercial framework outlined in the Appendix and the Exhibit to the Appendix .
- An indication as to how Dragon LNG Limited would fit into your overall strategy, sources of supply and markets for gas.
- A mark-up of the Term Sheet.
- Any particular preferences or restrictions as to gas offtake partners, either by name or by type of Partner.
- The volume of contracted annual throughput capacity in which you would have an interest (subject to a minimum of 2 bcm per annum) together with a description of likely seasonal variation.
- Your commentary on the structure (currency, variability, indices, etc.) and level of pricing of LNG to be supplied under a long term agreement, either at the unloading point or the delivery point of the Facility.
- Your commentary on the structure and level of prices for the Throughput Agreement.
- Your commentary on the technical configuration proposed for the project.
- Earliest possible and latest preferred start-up dates for delivery.
- Your preferred Throughput Agreement term – subject to a minimum of 15 years from first offtake.
- Your potential interest in the purchase of an equity stake in the Operator, and any

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comments or conditionality that you would wish to add in respect of ownership by parties other than Petroplus.

- Any other information which you consider may be relevant to Petroplus in determining its choice of Throughput Agreement partner, which has not been included elsewhere in the Expression of Interest.

Subsequent Process

Following the deadline for receipt of Expressions of Interest, Petroplus and Morgan Stanley will review the Expressions of Interest received and, at the sole discretion of Petroplus, selected parties will be invited to enter into the next stage of the negotiation process.

During the next phase of the process, Petroplus will negotiate an operational and economic framework with each of the selected parties and negotiate the terms, to be consistent with the Commercial Framework, of the Throughput Agreement to be entered into with each of them. Where appropriate, parties may be invited to co-operate in forming joint entities to contract as Customers under Throughput Agreements.

Petroplus intends at that time to provide the same parties, to the extent that they express an interest, with information that will permit them to submit offers to acquire equity interests in the Operator.

Timetable

The proposed timetable is:

Negotiations: [?]

Contracts: April [?]

NTS Auction: [?]

Final Contract: [?]

Financial Closing and Start Construction: [?]

Confidentiality

By accepting this letter and the Appendices to this letter together with the supplementary package of technical information (together the “Solicitation Documents”) you acknowledge and agree to keep confidential the information contained in them or made available in connection with them or with any further investigation of the Facility in accordance with and subject to the Confidentiality Agreement dated [?], [?], between you and Petroplus (the “Confidentiality Agreement”). The Solicitation Documents may not be photocopied, reproduced or distributed to any other person at any time except strictly in accordance with the terms of the Confidentiality Agreement. You should become familiar with this and the other obligations to which you are subject pursuant to the Confidentiality Agreement.

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Petroplus reserves the right to negotiate with one or more prospective interested parties at any time and to enter into a preliminary or definitive Throughput Agreement for gas with the Operator without notice to you or other prospective interested parties. Petroplus also reserves the right, without giving reasons therefore, at any time and in any respect to terminate discussions with any or all prospective parties or to negotiate at its sole discretion with any party with respect to the Throughput Agreement.

Other Matters

Any questions regarding the solicitation process should be directed, in writing, by fax or e-mail to Morgan Stanley to the attention of the Morgan Stanley representatives listed in the Appendix IV, acting on behalf of Petroplus. Under no circumstances should the management, employees, suppliers, regulatory authorities, affiliates, shareholders of Petroplus be contacted directly with regard to the Facility, nor should the Facility be discussed with any such individuals.

On behalf of Petroplus, we would like to thank you for your interest in this matter.

Kind Regards,

Melanie Chen
Executive Director
Morgan Stanley & Co
25 Cabot Square
Canary Wharf
London
E14 4QA

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Document 2; Commercial Framework (as originally appended to the Morgan Stanley Solicitation Letter)

- 1) Existing Assets** Petroplus currently runs a successful tank storage business at a site in Milford Haven, West Wales, that includes port facilities with underused capacity. Petroplus plans to develop the Facility on unused land at the site. The Facility will share some common facilities and services with the tank storage business, to be provided under contract by Petroplus.

- 2) Facility Development** Dragon LNG, as operator, proposes to construct the Facility. The Facility shall comprise the land, facilities (including the jetty and co-generation plant), assets and rights belonging to, or operated by, Dragon LNG at Milford Haven, Wales for the receipt, storage and regasification of LNG and delivery of Regasified LNG.

New facilities to be initially built on the site within the scope of the Facility will include new unloading facilities, two cryogenic tanks each of 160,000m³ with a working capacity of 154,000 m³ usable capacity and a regasification unit, together with piping and metering facilities to the plant gate. The physical assets of the Facility will include some of the existing Milford Haven site, fully permitted for planned initial development of the Facility, including use of a jetty and other infrastructure, together with the existing 21 MW cogeneration facility, which will be expanded. Low-pressure exhaust steam will provide all the heating needs of the regasification facility. The cogeneration plant will provide all the power needs of the Facility and generate surplus power for sale to Petroplus and the national grid.

Outline planning permission for the Facility has been granted and environmental processes for the Facility are now well advanced. [?]

- 3) Ownership** The existing site and assets are owned by Petroplus. It is planned that they will be transferred into Dragon LNG. Dragon LNG will raise finance with limited recourse to its shareholder(s) and will complete and own the Facility. Petroplus currently plans to sell 50-60% interest in Dragon LNG to others, which may include counterparties to the Throughput Agreements.

- 4) Operation** Petroplus will operate the Facility, either under contract to Dragon LNG or through dedicated staff employed by Dragon LNG under Petroplus direction.

**5) Project
Financing**

It is intended that the Throughput Agreements will be in terms that will support a conventional limited recourse debt financing by Dragon LNG of the Facility. Petroplus is to contribute assets (physical and intangible) of an approximate value of £[?] million. The estimated financing requirement for the Initial Facility net of the contribution of such assets is £[?] million, all of which is to be provided under the terms of the project debt facility. The threshold for the acceptability of the economics of the Throughput Agreements is therefore established by this constraint.

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Annex 3 EEA LNG TERMINALS (updated)

Country	Terminal	Owners	Start date	Existing capacity (bcm pa)	Existing + Potential capacity (bcm pa) 2010
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Existing Terminals

Spain	Huelva	Enagas	1988	4	12
Spain	Cartagena	Enagas	1989	4	12
Spain	Barcelona	Enagas	1969	11	12
Italy	La Spezia (Panigaglia)	Snam Rete Gas	1969	5	5
France	Fos sur Mer	GdF	1972	5	5
France	Montoir de Bretagne	GdF	1980	10	10
Greece	Revithouse	DEPA	2000	3	3
Belgium	Zeebrugge	Fluxys	1987	5	9
Spain	Bilbao	Repsol et al	2003	4	7
Portugal	Sines	GALP	2003	6	16
Sub-total				52	91

Expected Future Terminals

Spain	El Ferrol (Galicia)	Sonatrach, UF, et al	2004		4
Spain	Sagunto (Valencia)	Union Fenosa et al	2005		5
Italy	Rovigo	QP/EM/Edison	2007		8
Italy	Brindisi	BG	2007		8
France	Fos II	GdF	2006		8
France	Le Verdon	TFE	?		?
UK	Isle of Grain	National Grid Transco	2005		17
UK	Milford Haven	BG, Petronas, Petroplus	2007		12
UK	Milford Haven	EM/QP	2007		21
Sub-total planned terminals					83
Sub-total				52	174

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Other Potential Terminals

Italy	Livorno	BP/Edison/ Solvay (rejected by region – Platts 5/8/04)			3
Italy	Livorno	CrossGas/ Golar LNG – floating offshore – Platts 5/8/04	2005? (if approvals given)	?	?
Italy	Trieste	Gas Natural (Heren European Gas Markets 29/7/04)	2009		8
Italy	Taranto	Gas Natural (Heren European Gas Markets 29/7/04)	2009		8
Italy	Calabria 1				10
Italy	Calabria 2				8
Greece	New terminal				?
Netherlands	Eemshaven				?
Cyprus	Vasilikos				1
UK	Anglesey Island	Canataxx (LNG mooring bouy) Platts 28/7/04	2008		?
UK	Coryton	BP			?
Poland	Gdansk				?
Sub-total potential terminals					38

Total (existing + planned + potential)	212
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Dragon (12 bcm pa post-expansion) as % of Potential Market	6%
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Source: *Informal Application for Exemption From Regulated Third Party Access to UK LNG Facilities, Proposed LNG Terminal ("South Hook")*, 26 November 2003, ExxonMobil/Quatar Petroleum; with adjustments in bold

Annex 5: Use It Or Lose It Mechanism and Secondary Trading of Capacity.

Use it or Lose it Mechanism

Dragon LNG and its throughputters are incentivised to maximise utilisation of terminal capacity at all times.

Dragon is a separate legal entity and will produce separate accounts for LNG terminal activity.

Terminal Capacity

The terminal will be constructed by Dragon LNG to provide terminal capacity required to receive, temporarily store, regasify and process LNG consistent with the requirements of the Throughputters. The facilities have been designed to optimise supply of pipeline gas for redelivery at the exit point of the regasification plant. All of the terminal capacity is contracted for on a priority rights basis to the throughputters under the terms of the Throughput Agreement(s) with Dragon LNG.

Terminal capacity is expected to be defined in terms of the key capacity components associated with an LNG import and regasification terminal, namely:

1. Berthing slots
2. Working storage tank capacity for temporary LNG storage.
3. Regasification capacity.

Capacity Available for Sale to Third Parties

Under the terms of the Throughput Agreements, the Throughputters will have contracted for 100% of the terminal capacity. The Throughputters will be obliged to notify Dragon in the event that they do not expect to use any of their capacity entitlement.

In the event that there is capacity available which the Throughputters do not intend to use, Dragon will advertise this available capacity to the market in an appropriate electronic form such as on a website, together with dates by which applications for access are to be submitted and allocated or rejected. All other information necessary for third parties to determine their applications will be made available including:

- Quality specification ranges;
- All standard terms and conditions, including liabilities;
- Framework contract;
- Timing and priorities.

The standard technical terms and conditions between Dragon and third party applications for capacity will be the same or materially similar to those in force between Dragon and the

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Throughputters. Commercial terms for third party applicants will be offered on a non discriminatory basis.

- Applicant third parties who do not meet the criteria specified by Dragon, for example whose LNG supplies do not meet the quality specifications, or who cannot meet the liability requirements, will not be allocated capacity.
- The terms will reflect the obligation of Dragon to ensure that the founder Throughputters primary capacity rights are maintained.

The precise arrangements by which the market will be advised of available capacity will be developed and notified prior to first operation of the facility.

Dragon will be under an obligation to keep information regarding the activities of individual LNG suppliers and shippers in the terminal confidential from each other except where the provision of such information is required by the regulator or by Transco for the purposes of safe and reliable operation of the transmission network.

It is also expected that as part of the exemption conditions, Dragon and the Throughputters, and any third party users of the terminal will agree to provide any such information as may be required by Ofgem to enable it to perform its duties as the regulator under the terms of UK legislation.

Determination of allocation of available capacity

Dragon will operate a process that invites priced offers for the available capacity being offered by Dragon and where there is more than one qualifying user making an application, Dragon will allocate capacity so that preference will be given to the applicant whose access request allows revenues for Dragon to be maximised.

Secondary Trading of Capacity

The Throughput Agreements will enable secondary trading capacity between the Throughputters. Capacity not used by the Throughputters will be made available to third parties as outlined above.