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30 April 2007

Dear Colleague

**National Grid Grain LNG Ltd application for exemption from Section 19D of the Gas Act 1986 – Ofgem’s decision**

On 14 December 2006, Ofgem published a consultation document on the exemption application submitted by National Grid Grain LNG Ltd (GLNG) in relation to the phase 3 expansion project at the Isle of Grain LNG importation terminal (Grain 3). In the consultation document (the “December consultation document”)<sup>1</sup>, Ofgem set out its initial view that an exemption should be granted for this expansion project.

This letter sets out Ofgem’s final view on GLNG’s application for an exemption from regulated third party access (rTPA) requirements. It needs to be read in conjunction with the December consultation document<sup>2</sup>.

**Background**

GLNG is planning a third phase of development, to expand the Isle of Grain LNG importation terminal by up to 19.5mcm/d of import capacity (Grain 3). This will mean that overall the Grain facility will have a maximum import capacity of about 62 mcm/d. GLNG has applied for an exemption from the requirements of rTPA for this expansion. The requested duration of the exemption for Grain 3 is a maximum of 20 years or up to

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<sup>1</sup>‘National Grid Grain LNG application for exemption from Section 19D of the Gas Act 1986’.

Ref 212/06.

[http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/NGIncAdj/Documents1/212-06%20-%20Consultation%20\(National%20Grid%20Grain%20LNG%20Ltd%20application%20for%20exemption%20from%20Section%2019D%20of%20the%20Gas%20Act%201986\).pdf](http://www.ofgem.gov.uk/Markets/WhlMkts/EffSystemOps/NGIncAdj/Documents1/212-06%20-%20Consultation%20(National%20Grid%20Grain%20LNG%20Ltd%20application%20for%20exemption%20from%20Section%2019D%20of%20the%20Gas%20Act%201986).pdf)

<sup>2</sup> Where information and views expressed in our December consultation document remain unchanged, we have not sought to repeat them here.

October 2029 at the latest. GLNG has stated that the project will not proceed if an exemption is not granted.

GLNG is currently finalising an open season process to sell capacity at Grain 3. Firm bids were received in November 2006 and negotiations are currently being held with the bidder companies. As explained in our December consultation document, GLNG has given confidential information to Ofgem on the identity of the bidders and the maximum volume of capacity that existing customers at the Grain terminal might acquire.

### **Ofgem's initial views**

As set out above, our initial view was that an exemption should be granted in relation to Grain 3. The December consultation document explained the grounds on which we considered that GLNG has met each of the relevant criteria for such an exemption to be granted. In particular we did not consider that the exemption gave rise to competition concerns. The December consultation document also set out the basis on which we were minded to grant the exemption.

### **Respondents' views**

During the consultation process, we received 7 responses including one from the applicant GLNG and one from a fellow National Regulatory Authority (NRA). All these responses will be published on Ofgem's website ([www.ofgem.gov.uk](http://www.ofgem.gov.uk)) together with this letter.

The vast majority of respondents support Ofgem's granting of an exemption. Overall, respondents have emphasised the importance of implementing effective and duly monitored anti-hoarding mechanisms at Grain 3. None of the third party respondents have argued in favour of Ofgem substantially changing the scope, duration or conditions of the proposed exemption decision. There was one respondent that was opposed to issuing exemptions on a general level. However, this respondent emphasises the need for effective anti-hoarding mechanisms for Grain 3.

Where necessary, we provide in this letter a reply or a clarification to comments made by respondents to our December consultation document.

### **Additional information**

Following the publication of our December consultation document and in order to form our final views on the basis of the most accurate information, we have asked GLNG to provide us with all necessary updates of the project's financial information for Grain 3. As indicated to the applicant, we had a particular interest in understanding what assumptions may have changed (if any) to reflect the prices and conditions offered by bidders in the open season process. GLNG submitted the most up to date project financial model on a confidential basis, as up to April 2007. This was based on its latest estimation of the project returns (in view of the actual interest in primary capacity) as well as the reviewed overall project costs.

We have discussed further with the applicant some aspects of its financial model, in particular the capital structure of the project. GLNG has provided confidential evidence in order to demonstrate that the financial costs implied in the Grain 3 project are a reasonable representation of the overall risks and costs that the project will carry.

### **Ofgem's final views**

After giving due consideration to the responses received to the December consultation document we agree with the vast majority of respondents that an exemption should be

granted. Attached to this letter is the final exemption order granted by the Gas and Electricity Markets Authority (the "Authority").

We continue to believe that it is appropriate to grant the exemption order on the basis that certain on-going requirements are met. These relate to the outcome of the open season and to the implementation of effective anti-hoarding arrangements. They are explained later in this letter.

Ofgem continues to believe that the criteria<sup>3</sup> are met by the Grain 3 exemption application, for the reasons set out in the December consultation document. However, following the publication of our December consultation document and in view of the responses to our document we will provide further clarification in relation to conditions (b) investment risk and (e) competition, as explained below.

### **Investment risk**

In the December consultation we considered, on the basis of an overall assessment of the risks involved in the Grain 3 project, that it meets condition (b), ie the level of risk is such that the investment would not be or would not have been made without the exemption.

Ofgem's initial view was that the suggested definition, set out in the interpretative note of DG Energy and Transport of January 2004 (the "Interpretive Note"),<sup>4</sup> of a "major" or "high cost" piece of infrastructure in relation to this condition was an appropriate indicator to be taken into account. The Interpretive Note defines these as projects that would significantly increase final customers' bills if underwritten by regulated tariffs. A rule of thumb of such an increase given by the Interpretive Note was more than €10 per connected customer<sup>5</sup>.

In the assessment of this condition we not only took into account the illustrative rule set out in the Interpretive Note but also looked at factors such as the long payback period of the project and the importance of obtaining certainty over returns during that period to enable the project to proceed (see below a further explanation to our final approach to the duration of the exemption). This uncertainty is compounded by several factors including potentially significant changes in wholesale gas prices, the potential impact of competing gas supply projects and advances in technology over the payback period.

One respondent contended that the 'rule of thumb' application of condition (b) given in the Interpretive Note might unintentionally incentivise GLNG to adopt more expensive project options for Grain 3 in order to qualify for an exemption. Whilst there may be scope to refine this test, we note it is not the only factor relevant in the risk assessment, and in any case this test is meant as a rough guideline.

On the basis of the updated information we received from GLNG, we remain of the view that condition b) is met.

### **The impact on competition of an rTPA exemption**

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<sup>3</sup> See page 6 to 19 of the December Consultation Document for a full overview of the criteria.

<sup>4</sup> Note of DG Energy and Transport on Directives 2003/54-55 and Regulation 1228/03 in the Electricity and Gas Internal Market - Exemptions from Certain Provisions of the Third Party Access Regime. 30.1.2004.

[http://ec.europa.eu/energy/electricity/legislation/doc/notes\\_for\\_implementation\\_2004/exemptions\\_tpa\\_en.pdf](http://ec.europa.eu/energy/electricity/legislation/doc/notes_for_implementation_2004/exemptions_tpa_en.pdf)

<sup>5</sup> Page 2 of the Note.

The vast majority of respondents agreed that the competition assessment in the December consultation document was complete and that it provided sufficient information on which to comment. No respondents objected to the underlying assumptions used in the analysis. With regard to the suggestion of a narrower LNG only market definition, no respondent argued that a narrower market definition should be used. Finally, the vast majority of respondents agreed that issuing an exemption would have no detrimental impact on competition.

The analysis in the December consultation document looked at several potential market definitions and used these to come to a view on whether or not the exemption would have a detrimental impact on competition. In the December consultation document we considered upstream markets (the LNG commodity market and the broader market for flexible gas supplies) and downstream markets. We considered concentration levels on each relevant market in 2010 (when Grain 3 is projected to come on-line), in both a situation where an exemption is granted for Grain 3 and on a hypothetical rTPA situation. The results of this analysis were taken into account together with other circumstances in order to assess the impact on competition of the proposed exemption. Among those circumstances, the role to be played by effective anti-hoarding measures was central for us to conclude that the exemption would not be detrimental to competition.

Since publishing the December consultation document we have considered the possibility of a market for LNG importation capacity. This issue was not raised by respondents to the consultation, but forms part of our wider thinking around this subject. Where an LNG shipment requires direct access to the GB market, at the moment there are only very limited routes via the Grain 1 entry terminal and potentially Zeebrugge<sup>6</sup>. This will of course change through time as more terminals develop both in GB and in North West Europe (for example the Netherlands currently has 3 proposals for new LNG import terminals where gas will be able to flow through BBL). Ofgem will continue to monitor developments in the LNG importation market. However, current information regarding new LNG terminals indicates that this market will be competitive in 2010. Therefore, we consider that with effective anti-hoarding and secondary trading arrangements it will not be possible for a primary capacity holder to act to distort competition in this market.

We remain of the view that the granting of the exemption would not have a detrimental impact on competition, for the reasons set out in the December consultation document.

It must be noted that Ofgem looks at each exemption on a case by case basis. The GB gas market is in a stage of transition where the historical sources of gas in the North Sea are declining and new sources of gas are coming on-line. In addition, changes are a-foot in the North West European gas market. Ofgem will continue to monitor market developments closely and may find it necessary to define the market differently in subsequent cases.

### **Scope and duration of the exemption**

In our December consultation document, we proposed that the exemption should cover all the new capacity at Grain 3 (up to around 5mtpa) for a maximum duration of 20 years or until October 2029 at the latest, as requested by GLNG.

Our initial view on the duration of an exemption was based on GLNG's confidential submission outlining details of the project's financial information. We noted that given the

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<sup>6</sup> Bringing gas from Zeebrugge would involve a gas swap as gas can not be transported from the LNG terminal to IUK in Zeebrugge due to gas quality constraints.

long pay back period in relation to Grain 3, an exemption shorter than that duration might offer insufficient returns. We also noted, for illustration, that a number of comparable projects have been granted exemptions from rTPA with a comparable duration.

Six respondents have expressed their view as to the appropriate duration of the exemption, all of which agree with the duration proposed by GLNG. Among these, two responses mention the fact that this duration is coincident with the duration of other rTPA exemptions and two responses favour the matching of the exemption duration with the duration of the long term contracts for primary capacity at the terminal.

As set out above, GLNG has submitted the most recent financial information for Grain 3 on a confidential basis, as up to April 2007. Following the submission by GLNG of the latest financial model, we have tested GLNG's assumptions with an aim to ensure that the implied payback period of the project represents a realistic assumption given the circumstances of the project and the company. In this context GLNG has provided confidential third party evidence in order to support its assumptions on the cost of capital for Grain 3.

On the basis of that information and our own analysis, we have concluded that a realistic payback period of the project would not be significantly shorter than 19 years.

In our December consultation document we proposed to grant an exemption for a maximum of 20 years from the start of commercial operations or up to October 2029 at the latest. We have changed the formulation of the exemption duration in two senses.

First, in order to ensure that the exemption duration is as adjusted as possible to the shortest reasonable payback period, it is now granted for a maximum of 19 years<sup>7</sup>.

Second, to ensure that an unexpected delay in the target commissioning date for Grain 3 (October 2010) does not reduce in practice the maximum duration of the exemption, we have lifted the fixed time limit we previously set in 2029. This limit was introduced following GLNG's own application for an exemption. However, the company has indicated to us its preference to not have an exemption subject to a fixed time limit.

We note that a potential minor delay in the commissioning would not necessarily change our conclusion that the criteria for an exemption being granted are met, provided the exemption duration is not more than 19 years in any scenario. Moreover, should the commissioning of Grain 3 be significantly delayed beyond October 2010, the Authority would be able to revoke the exemption if it finds that the relevant criteria are no longer met.

### **Conditions attached to the exemption**

As proposed in the December consultation document, we intend to grant the exemption on the basis that certain ongoing requirements are met. These are discussed below.

#### *Conditions in relation to the outcome of the open season process*

We have analysed whether the tests for granting the exemption have been met within the constraints set out in the undertakings provided by GLNG (as outlined in Appendix 5

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<sup>7</sup> In the above mentioned Interpretative Note the EC suggested that "the exemption should not be significantly longer than the period during which the project is expected to "break even"".

of the December consultation document). Once the final capacity allocation is known, and in particular in the event that the outcome is different from that represented by the undertakings provided by GLNG, the Authority may re-examine whether GLNG meets all the relevant criteria; and may modify or revoke the exemption within four months if it were to find that the relevant criteria are no longer met. In this way, the exemption is conditional on the outcome of the open season process.

We asked respondents whether they agree with the inclusion of such a condition; five respondents have given their views and the majority of these support the introduction of the condition. In view of the responses received we note however that some clarification is needed with regard to this condition.

Paragraph E3 of the exemption order neither requires nor pre-judges the need for a review (as one respondent thought it might). Rather, in the event that capacity is awarded in such a way that would, in the Authority's reasonable opinion, result in a material change in the degree to which certain conditions are met with respect to the facility, it simply provides that the Authority may revoke the exemption within four months of the notification, by GLNG, of the identity of the capacity holder(s).

This paragraph, in effect, allows for a "fast track" revocation in the event that the information upon which the Authority made its initial decision to grant the exemption changes. It is without prejudice to the provisions of paragraph E4 of the exemption order, which sets out the circumstances in which the Authority may revoke the exemption order by giving the facility owner not less than four months notice.

For the sake of clarity it also needs to be explained that the undertakings provided by GLNG were voluntarily submitted by the applicant on the basis of actual bids received in the open season process. Ofgem does not pose any limit on those bids but limits itself to verifying that the exemption criteria are met on the basis of the actual or expected outcome of the open season process.

Given the importance in our assessment of the exemption of the undertakings submitted by GLNG in relation to the outcome of the open season, we remain of the view that this condition needs to be included in the exemption order issued by the Authority.

#### *Implementation of effective anti-hoarding arrangements*

Consistent with Ofgem's exemption policy, in our December consultation document we explained that an exemption order would be granted only on the basis that effective secondary trading and anti-hoarding mechanisms would be implemented. The implementation of effective anti-hoarding arrangements is crucial in assessing the impact on competition of an exemption from rTPA requirements. All respondents agreed that the Grain 3 exemption order should be granted on the basis that effective anti-hoarding arrangements would be put in place.

Given that GLNG has stated, in its application, that it will put in place effective anti-hoarding arrangements, we are of the view that the exemption order may be granted. It should be noted that condition D1 of the exemption order requires that the material provided to the Authority in respect of the exemption order is and remains accurate in all material respects. It should also be noted that failure of GLNG to put in place such arrangements, could give Ofgem grounds for amendment or possible revocation of the exemption order. In the event that any of the circumstances occur that allow Ofgem to amend or revoke the exemption order, Ofgem would issue a consultation on the issue.

In our initial views document we also consulted on our intention to publish a guidance note on the design of effective anti-hoarding arrangements for LNG importation terminals. The publication of an anti-hoarding guidance note has been welcomed by the

vast majority of respondents. We therefore maintain our commitment to publish a guidance note.

In this guidance note we will outline a number of key high level principles for such arrangements. Such guidance will only be indicative and parties will need to satisfy themselves that the arrangements they have in place are effective in preventing hoarding by capacity holders. We currently aim to consult the market on this guidance note during Q2 of 2007.

One respondent (the Belgian regulator, CREG), deemed necessary the approval by Ofgem of detailed anti-hoarding mechanisms prior to the granting of a Grain 3 exemption. We do not consider the ex ante approval by the regulator of anti-hoarding arrangements to be appropriate in the current circumstances. We therefore do not propose approving such arrangements prior to their necessary implementation by GLNG (or the Grain 3 shippers on its behalf).

### **Way forward**

Our decision to grant an exemption from rTPA requirements for Grain 3 will be notified to the European Commission, which can request Ofgem to amend or withdraw its decision within two months following notification<sup>8</sup>.

I hope that you find this letter useful. Should you wish to discuss any aspect of it in more detail, please feel free to contact me or Carlos Martinez on 020 7901 7070.

Yours sincerely



Sonia Brown  
**Director, European Strategy and Sustainable Markets**

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<sup>8</sup> This period may be extended by one additional month where additional information is sought by the Commission. The veto procedure is detailed in the Second Gas Directive, as referred to in Appendix 3 of the Grain 3 Consultation document- Legal and Policy Regime for exemptions from rTPA.





**GAS ACT 1986**  
**SECTION 19C**

**EXEMPTION ORDER**

Pursuant to sub-section 19C(5) of the Gas Act 1986 (the "Act"), the Gas and Electricity Markets Authority hereby issues to National Grid Grain LNG Limited,<sup>1</sup> as the owner of an LNG import facility, an exemption from the application of section 19D of the Act in relation to the increase in capacity at the LNG import facility located at the Isle of Grain, Nr Rochester, Kent ME3 0AB following completion of the third phase of the development of that facility, subject to the terms and conditions in the attached Schedule.



**Sonia Brown**

Authorised in that behalf by the  
Gas and Electricity Markets Authority

Dated 30 April 2007

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

*SCHEDULE*

*PERIOD, CONDITIONS, AND REVOCATION OF EXEMPTION ORDER*

**A. Interpretation and Definitions**

In this exemption order:

the “Authority”	means the Gas and Electricity Markets Authority established by section 1(1) of the Utilities Act 2000, as amended from time to time;
the “Act”	means the Gas Act 1986, as amended from time to time;
the “capacity holder”	means the person or persons to whom the primary capacity at the facility has been awarded;
the “facility”	means the increase in capacity at the LNG import facility following completion of the third phase of the development of that facility, namely:  (a) the increase in capacity at the LNG import facility as at the date that the third phase of the development commences commercial operation; or  (b) an increase in capacity at the LNG import facility of 7.1 billion cubic meters per year,  whichever shall be the less;
the “facility	means National Grid Grain LNG Limited (a company

owner”	registered in England and Wales under company number 4463679 and whose registered office is situated at 1–3 Strand, London WC2N 5EH), in its capacity as owner of the facility;
The “LNG import facility”	means the LNG import facility located at the Isle of Grain, Nr Rochester, Kent ME3 0AB;
“open season process”	means the process to offer the capacity at the facility to the market;
“primary capacity”	means the capacity at the facility acquired from the facility owner pursuant to the first open season process;
“relevant gas transporter”	means any holder of a gas transporter licence under section 7 of the Act owning a transportation system within Great Britain to which the facility is connected or with whom the operator of the facility interfaces as a system operator;
“throughputter”	means any user of the facility.

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

This exemption order relates to the third phase of the development of the LNG import facility, namely: (a) the increase in capacity at the LNG import facility as at the date that the third phase of the development commences commercial operation;

or (b) an increase in capacity at the LNG import facility of 7.1 billion cubic meters per year, whichever shall be the less;

### **C. Period**

Subject to section E below, and pursuant to section 19C(3)(a) of the Act, this exemption order shall come into effect on the date that it is issued and will continue for a period of 19 years from the date that the facility commences commercial operation.

### **D. Conditions**

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

1. The material provided by the facility owner to the Authority in respect of this exemption order is and remains accurate in all material respects.
2. The facility owner must notify the Authority within ten days of the facility commencing commercial operation.
3. The facility owner must, within ten days of the primary capacity being awarded, notify the Authority of:
  - (a) the identity of each capacity holder; and
  - (b) the amount of primary capacity awarded to each capacity holder.
4. The facility owner must furnish the Authority, in such manner and at such times as the Authority may reasonably require, with such information as the Authority may reasonably require, or as may be necessary, for the purpose of:
  - (a) performing the functions assigned to it by or under the Act, the Utilities Act 2000 or the Energy Act 2004; or

(b) monitoring the operation of this exemption order.

5. The facility owner must comply with any direction given by the Authority (after the Authority has consulted the relevant gas transporter and, where relevant, the Health and Safety Executive) to supply to the relevant gas transporter such information as may be specified or described in the direction:

(a) at such times, and in such form and such manner; and

(b) in respect of such periods,

as may be so specified or described in the direction.

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

In this paragraph, “information” means information relating to the operation of the pipe–line system which is operated by a relevant gas transporter.

6. Should any of the grounds for revocation arise under section E of this exemption order, the Authority may, with the consent of the facility owner, amend rather than revoke this exemption order.

7. The Authority may, with the consent of the facility owner, amend this exemption order where the Authority has been requested to amend the decision to grant this exemption order by the European Commission (such request being made in accordance with Article 22(4) of Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003).

8. This exemption order is transferable to another person where the Authority has given its written consent to such a transfer. For the avoidance of doubt, all of

the conditions contained in this exemption order (as amended from time to time) continue unaffected in respect of any person to whom this exemption order may be transferred (and as if the transferee was substituted in the definition of the “facility owner”).

#### **E. Revocation**

Pursuant to sub-section 19C(4) of the Act, this exemption order may be revoked in the following circumstances:

1. The Authority may revoke this exemption order where the European Commission has requested (in accordance with Article 22(4) of Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003) that the Authority withdraw the decision to grant this exemption order.
2. The Authority may revoke this exemption order where the European Commission has requested (in accordance with Article 22(4) of Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003) that the Authority amend the decision to grant this exemption order and the facility owner does not agree (under paragraph D7 above) that this exemption order be amended in the manner so requested by the European Commission.
3. The Authority may, within four months after the notification by the facility owner of the identity of the capacity holder (in accordance with paragraph D3 above), revoke this exemption order if the award of the primary capacity, in the Authority’s reasonable opinion, results in a material change in the degree to which the requirements of sub-section 19C(7)(a) or (e) are met with respect to the facility.

4. In addition to the provision of paragraph E3, the Authority may revoke this exemption order by giving a notice of revocation to the facility owner not less than four months before the coming into force of the revocation where:
- (a) in the Authority's reasonable opinion there is a material change in the degree to which the requirements of sub-sections 19C(7)(a), (c), (d) or (e) of the Act are met with respect to the facility as the result of any action or omission of the facility owner, operator of the facility or throughputter;
  - (b) the facility owner has a receiver (which expression shall include an administrative receiver within the meaning of section 251 of the Insolvency Act 1986) of the whole or any material part of its assets or undertaking appointed;
  - (c) the facility owner has entered administration under section 8 of and Schedule B1 to the Insolvency Act 1986;
  - (d) the facility owner is incorporated or has assets in a jurisdiction outside England and Wales and anything analogous to any of the events specified in sub-paragraphs (b) and (c) above occurs in relation to the facility owner under the law of any such jurisdiction;
  - (e) the facility owner is found to be in breach of any national or European competition laws, such breach relating to the facility;
  - (f) there is merger or acquisition in relation to or by the facility owner that is, or is likely to be, detrimental to competition;
  - (g) the facility owner has failed to comply with a request for information issued by the Authority under paragraph D4 above and the Authority has written to the facility owner stating that the request has not been complied with and

giving the facility owner notice that if the request for information remains outstanding past the time specified in the notice given under paragraph D4, the exemption may be revoked; or

(h) the facility owner has failed to comply with a direction issued by the Authority under paragraph D5 above and the Authority has written to the facility owner stating that the direction has not been complied with and giving the facility owner notice that if the direction remains outstanding past the time specified in the notice given under paragraph D5, the exemption may be revoked.