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To all interested Parties

5 July 2005

Decision on an application by Caythorpe Gas Storage Limited for an exemption under section 19A(6)(a) of the Gas Act 1986 from section 19B of the Gas Act 1986

This document provides details of an application by Caythorpe Gas Storage Limited (CGSL), a wholly owned subsidiary of Warwick Energy Limited (WEL), for an exemption under section 19A(6)(a) of the Gas Act 1986 (the Gas Act) from the negotiated third party access (TPA) requirements contained in section 19B of the Gas Act. The application relates to the proposed gas storage facility to be located in Caythorpe, East Yorkshire. This document also provides Ofgem's decision on the application.

Background

As a result of the entry into force of the Second EU Gas Directive¹ there have been a number of important changes made to the legal and regulatory framework applying to gas storage facilities in Great Britain (GB). These changes were made through the Gas (Third Party Access) Regulations 2004 (the 2004 Regulations), which transposed, in part, the Second Gas Directive into GB law. The 2004 Regulations came into force on 26 August 2004. On 25 November 2004, Ofgem published a document² setting out a summary of the changes made to the Gas Act as a result of the 2004 Regulations and set out its view on their impact on new and proposed gas storage facilities.

In summary, although the 2004 Regulations did not result in any material changes to the nature of the negotiated TPA requirements for gas storage, which are set out in section 19B of the Gas Act, a number of significant changes were made to section 19A of the Gas Act, which allows for owners of storage facilities to be granted exemptions from these TPA requirements. In particular, for new storage facilities or for existing facilities which are, or are to be, modified to provide for a significant increase in capacity, section 19A of the Gas Act now provides two routes for exemption: the facility may be granted an exemption if either: use of the facility by other persons is not necessary for the operation of an economically efficient gas market; or, if the six exemption requirements contained in section 19A(8) of the Gas Act are met³.

¹ Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC.

² Ofgem, *The Second EU Gas Directive and storage regulation Great Britain*, November 2004. This document can be found under the 'Europe' area of work on Ofgem's website.

³ The six exemption requirements are contained in section 19A(8) of the Gas Act 1986 and are set out below:

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

In respect of a facility which is, or is to be, modified to provide for a significant increase in its capacity, section 19A of the Gas Act specifies that, where an exemption is given on the basis that the use of the facility by other persons is not necessary for the operation of an economically efficient gas market, the exemption may be given in relation to the whole of the capacity of the facility or any significant increase in the capacity of the facility⁴, but where an exemption is given on the basis that the six exemption requirements contained in section 19A(8) are met, the exemption may only be given in relation to that increase in its capacity.

The Caythorpe gas storage facility

WEL, through subsidiary companies, owns and operates the Caythorpe gas field near Bridlington in East Yorkshire. The field, which produces gas from conventional porous strata, was put on production in 1992 and will be nearly fully depleted by 2007 under its current operating regime. WEL plans to convert the depleted gas field into a gas storage facility and intends to commence gas storage operations at Caythorpe in mid-2007. The facility will be built, owned and operated by Caythorpe Gas Storage Limited.

WEL has stated in its application that the ultimate capacity of the project is a function of the reservoir size, the number of wells drilled and the size of the compression facilities. However, WEL suggests that the maximum capacity of the facility will not exceed 3000GWh of space with 120GWh/day of peak deliverability and 90GWh/day of peak injectability.

It is intended that the Caythorpe storage facility will have a single customer who will commit to paying capacity fees to CGSL on a long term basis in return for rights to store gas in the facility.

On 24 February 2005, WEL wrote to Ofgem under section 19A(2) applying for an exemption under section 19A(6)(a) of the Gas Act from the application of section 19B of the Gas Act for the planned Caythorpe gas storage facility on the basis that the use of the facility by other persons is not necessary for the operation of an economically efficient gas market.

Ofgem's initial views

On 15 March 2005, Ofgem consulted on CGSL's application for an exemption. Ofgem considered that, based on the information available to Ofgem, the Caythorpe gas storage facility, with an estimated 3000GWh of space, would constitute around seven per cent of the overall market for existing (maximum) gas and LNG storage space in GB. Based on the market definition provided by the Competition Commission⁵ in relation to maximum daily flexibility, the facility's estimated deliverability of 120GWh/day would constitute around three per cent of the overall existing market for flexibility in GB. If a more narrow approach was adopted to the

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- (b) the level of risk is such that the investment to construct the facility or (as the case may be) to modify the facility to provide for a significant increase in its capacity would not be or would not have been made without the exemption;
 - (c) the facility is or is to be owned by a person other than the gas transporter who operates or will operate the pipeline system connected or to be connected to the facility;
 - (d) charges will be levied on users of the facility or (as the case may) the increase in its capacity;
 - (e) the exemption will not be detrimental to competition, the operation of an economically efficient gas market or the efficient functioning of the pipeline system connected or to be connected to the facility; and
 - (f) the Commission of the European Communities is or will be content with the exemption.

⁴ See also the definition of 'new facility' in section 19E of the Gas Act.

⁵ Competition Commission, *Centrica plc and Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd*, August 2003, Table 5.9.

definition of the flexibility market – to the flexibility provided by existing and likely future medium duration storage facilities⁶, the facility's estimated deliverability would represent around 11 per cent of this market.

Ofgem's initial view was that, on the basis of the size of the market share that the Caythorpe gas storage facility would represent in the market for storage space and for flexibility (under both market definitions), the use of the facility by other persons is not necessary for the operation of an economically efficient gas market. Ofgem's initial view, therefore, was that an exemption should be granted to CGSL under section 19A(6)(a) of the Gas Act from the TPA requirements in section 19B of the Gas Act in respect of the whole of the capacity of the Caythorpe gas storage facility. Ofgem invited responses on its initial views and on the draft exemption order to be received by close of business 29 April 2005.

Respondents' views

Ofgem received three responses to the consultation. Two of these responses can be found in full on the Ofgem website with the remaining response being confidential. One of the respondents agreed with Ofgem's initial view that the use of this storage facility by other persons is not necessary for the operation of an economically efficient gas market and that it would therefore be appropriate to grant the exemption. The other two respondents did not agree with Ofgem's initial view.

One respondent considered that Ofgem was right to consider the whole flexibility market and not just traditional gas storage, as storage assets are just one source of flexibility, and it is the result of the service and not the physical characteristics of a particular form of flexibility that matter to market participants.

Two respondents expressed the view that, based on when the Caythorpe gas storage facility is expected to be operational, the facility may have a substantial share of the space and flexibility markets for medium duration storage facilities. Further, one of these respondents was of the view that, although the impact of individual exemptions may be questionable, there are concerns that the extension on a case by case basis of exemption to an increasing number of new storage facilities may, in aggregate, both reduce the efficiency of operation of the gas market and distort the operation of the market in gas storage itself. This respondent also expressed the view that Ofgem should consider granting time limited exemptions where the long term effect on competition can be re-assessed at some pre-identified time.

Ofgem's final view

Ofgem agrees with the view of one respondent that it is appropriate to consider the whole flexibility market and not just traditional gas storage, as storage assets are just one source of flexibility. However, Ofgem notes the views of two respondents that, based on when the Caythorpe gas storage facility is expected to be operational, the facility may have a substantial share of the space and flexibility markets for medium duration storage facilities.

⁶ For the purpose of this calculation Hatfield Moor, Hornsea and Hole House are classified as existing medium duration storage facilities, and the Humbly Grove, Welton, Aldbrough and Byley storage facilities are classed as the likely future medium duration storage facilities. Ofgem considers that this interpretation is consistent with Table 4.5B of Transco's Transportation Ten Year Statement 2004 on the basis that 'likely future' storage facilities are those that have progressed beyond the 'conceptual' stage.

Ofgem considers that there are two key issues to consider in this regard. First, Ofgem considers that there is no single definitive market definition for such analysis, particularly in relation to the market for flexibility. The difficulties associated with defining the relevant market for flexibility were acknowledged by the Competition Commission in its report on the purchase of Rough and, in order to attempt to address these difficulties, Ofgem has presented two approaches to the definition of market shares in this document, one a broad definition and one a narrow definition. Ofgem considers that it is not appropriate to rely solely on a narrow definition of the markets for space and flexibility, i.e. that relevant to medium duration storage facilities, since the distinction between short, medium and long duration storage facilities⁷ is not based on a clear distinction by product markets.

Second, Ofgem does not consider that it is appropriate to narrow the temporal window over which the assessment is made to only that up to when the Caythorpe gas storage facility is expected to be operational. Ofgem considers that, based on market intelligence, a number of storage facilities can be expected to become operational in the next few years. However, until such facilities actually become operational, a judgement must be made as to which facilities should be included for the purpose of calculating market shares. Ofgem is of the view that classing the Humbly Grove, Welton, Aldbrough and Byley storage facilities as likely future medium duration storage facilities is reasonable. Indeed, Ofgem considers that the time horizon could be extended further to include other potential future storage facilities, further broadening the market definition. In addition, it should be recognised that, although Ofgem has not included all potential future storage facility projects in its market definition, these potential projects indicate that investors are responding to market signals to invest and that the likelihood of such investment is not merely theoretical but represents an actual competitive constraint on the behaviour of those already operating in the market.

Another issue highlighted by one of the respondents was the potential for a cumulative adverse effect on competition as a result of a number of exemptions being given. When considering any exemption application, Ofgem makes its assessment of whether the use of the facility by other persons is not necessary for the operation of an economically efficient gas market in light of the current and likely future state of the gas market. In conducting its assessment, therefore, Ofgem assesses the potential for any adverse affect on competition that could arise as a result of the cumulative effect of a number of exemptions already having been given. This is because the fact that any such exemptions had been given would form part of its view of the current and likely future state of the gas market. Ofgem considers that this approach is appropriate since it allows it to respond to changes in the market in a considered and relevant manner.

In relation to the potential need for time limited exemptions, Ofgem would like to note that its current approach in relation to exemptions given under section 19A(6)(a) of the Gas Act is to include a revocation condition to the effect that the exemption could be revoked if the Authority considers that the use of the facility by other persons becomes necessary for the operation of an economically efficient gas market (see section E of the exemption order in Appendix 1 of this document). Ofgem would like to note that, in the event that any of the circumstances occur which may give rise to the need to amend or revoke an exemption, in the absence of a need to act urgently, Ofgem would likely consult interested parties before any action is taken.

⁷ A short duration storage facility is where the total storage duration is less than ten days; a medium duration storage facility is where the total storage duration is ten or more days but less than 30 days; and a long duration storage facility is where the total storage duration is equal to or greater than 30 days.

Having considered respondents' views, Ofgem remains of the view that use of the facility by other persons is not necessary for the operation of an economically efficient gas market. The Authority has therefore granted CGSL an exemption in respect of the entire capacity of the proposed Caythorpe gas storage facility under section 19A(6)(a) of the Gas Act from the TPA requirements in section 19B of the Gas Act. This exemption order is set out in Appendix 1 of this document.

The way forward

The attached exemption order (at Appendix 1) will be in effect from 5 July 2005.

If you wish to discuss any matters in this document, please contact Matthew Buffey on 0207 901 7088 or Liz Chester on 0207 901 7403

Yours sincerely

A handwritten signature in black ink, appearing to read 'Sonia Brown'.

Sonia Brown
Director, Markets

Appendix 1: Exemption order

GAS ACT 1986 SECTION 19A EXEMPTION

Pursuant to sub-section 19A(6)(a) of the Gas Act 1986 (the Act), the Gas and Electricity Markets Authority hereby gives to Caythorpe Gas Storage Limited⁸, as a person who expects to be an owner of a storage facility, an exemption from the application of section 19B of the Act in respect of the storage facility located at Caythorpe, near Bridlington, East Yorkshire, subject to the attached Schedule.



Sonia Brown

Authorised in that behalf by the
Gas and Electricity Markets Authority
Dated 5 July 2005

⁸ Registered in England No. 5283117. Registered Office: Wellesbourne House, Wellesbourne, Warwickshire, CV35 9JB.

SCHEDULE
PERIOD, CONDITIONS, AND REVOCATION OF EXEMPTION

A. Interpretation and Definitions

In this exemption:

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| "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 facility" | means the Caythorpe storage facility |
| "facility owner" | means Caythorpe Gas Storage Limited in its capacity as owner of the storage facility |
| "facility operator" | means Caythorpe Gas Storage Limited in its capacity as operator of the storage facility |

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

The capacity of the facility, being up to 3000GWh.

C. Period

Subject to section E below, and pursuant to section 19A(3)(a) of the Act, this exemption shall come into effect on the date that it is issued and will continue until it is revoked in accordance with Section E.

D. Conditions

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

1. That the material provided by the facility owner, or on behalf of the facility owner by a third party, to the Authority in respect of this exemption is accurate in all material respects.
2. The facility owner furnishes 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, each as amended from time to time; or
 - (b) monitoring the operation of this exemption.
3. The facility owner complies 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, in such form and such manner; and
 - (b) in respect of such periods,as may be so specified or described.

Where 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 condition:

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| "information" | means information relating to the operation of the pipe-line system which is operated by a relevant gas transporter |
| "relevant gas" | means any holder of a gas transporter licence under |

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| transporter” | section 7 of the Act owning a transportation system within Great Britain to which the facility is connected or with whom the facility operator interfaces with as a system operator |
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4. Should any of the grounds for revocation arise under section E of this exemption, the Authority may, with the consent of the facility owner, amend this exemption rather than revoke the exemption.
5. The Authority may, with the consent of the facility owner, amend this exemption.
6. This exemption is transferable to another facility owner 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 continue unaffected in respect of any facility owner to whom this exemption order may be transferred.

E. Revocation

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

1. This exemption may be revoked by the Authority by giving a notice of revocation to the facility owner not less than four months before the coming into force of the revocation in any of the following circumstances
 - (a) where:
 - (i) the Authority considers that the use of the facility by other persons is necessary for the operation of an economically efficient gas market;
 - (ii) the facility owner has a receiver (which expression shall include an administrative receiver within the meaning of section 251 of the Insolvency Act 1986, as amended from time to time) of the whole or any material part of its assets or undertaking appointed;

- (iii) the facility owner has an administration order under section 8 of the Insolvency Act 1986, as amended from time to time, made in relation to it;
 - (iv) the facility owner is found to be in breach of any national or European competition laws, such breach relating to the facility; or
 - (b) the facility owner has failed to comply with a request for information issued by the Authority under paragraph D2 above and the Authority has written to the facility owner stating that the request has not been complied with and giving the facility owner notice that if the request for information remains outstanding past the period specified in the notice, the exemption may be revoked; or
 - (c) the facility owner has failed to comply with a direction issued by the Authority under paragraph D3 above and the Authority has written to the facility owner stating that the direction has not been complied with and giving the facility owner notice that if the direction remains outstanding past the period specified in the notice, the exemption may be revoked.
2. This exemption may be revoked by the Authority with the consent of the facility owner.