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Dear Sonia,

National Grid Grain LNG Ltd application for exemption from Section 19D of the Gas Act 1986 – Consultation Response

Thank you for this opportunity to comment on Ofgem's proposal to grant National Grid Grain LNG ("Grain LNG") an exemption from Section 19D of the Gas Act 1986 in respect of the proposed third phase of development at the Isle of Grain LNG importation facility ("Grain 3").

Grain LNG welcomes Ofgem's initial view that Grain 3 meets all the necessary criteria for the granting of an exemption from the regulated third party access (rTPA) requirements ("exemption") and that an exemption order should be granted. We appreciate Ofgem's efforts in considering Grain LNG's evidence and are pleased it has concluded it appropriate to grant such exemption for a period of 20 years or to October 2029 at the latest.

Our main comments regarding the consultation are provided below and our responses to your specific questions are provided in the appendix to this letter.

Consistency

Subject to market interest, the Grain 3 expansion will provide an additional throughput of up to 5 million tonnes per annum (mtpa) of LNG from October 2010 at the earliest. This is in addition to the 9.8mtpa of total capacity that will be available from October 2008 following completion of the second phase of development at the Isle of Grain facility. The exemption requested in our application is required to ensure that Grain 3 proceeds.

Grain LNG offered the Grain 3 capacity to the market through a third 'open season' auction process, a mechanism considered by the EC to be consistent with rTPA¹. The sale process is also consistent with that followed in the previous phases at the Isle of Grain LNG importation facility, both of which have been granted exemptions. As existing customers at the Grain facility could acquire Grain 3 expansion capacity an exemption substantially in the

¹ *LNG facilities and interconnectors: EU legislation and regulatory regime, Ofgem/DTI initial views, June 2003 para 5.3*

same form as that granted for phase 1 and 2 is essential to ensure not only that the project can proceed, but also to ensure consistency of treatment across customers.

By the time Grain 3 commences commercial operations in October 2010 at least two other rTPA exempt LNG importation terminals will be operational in the UK. The Grain facility will already have 4 existing customers. This will be in addition to other new UK importation capacity, for example via the recently commissioned BBL interconnector, the Langeled pipeline and the further reinforced I(UK). Grain 3 and its customers will adopt UIOLI and secondary trading arrangements consistent with other phases/facilities in the UK. Therefore, Grain 3 will come on stream at a time when there will be significantly greater capacity to access the wholesale gas market and the anti-hoarding mechanisms in place across terminals will ensure 3rd parties can access any unused LNG importation capacity via the secondary market from a number of competing sources. Consequently, the concerns expressed by some market players last winter regarding access to LNG importation capacity should naturally be alleviated.

Timing

We feel it may be helpful for respondents to understand the timing requirements for the Grain 3 exemption and, in particular, why it is important for the exemption application to be processed prior to Grain 3 capacity being allocated to Shippers.

As with any major construction project, to keep the overall lead-time to a reasonable and practical level, there is a requirement to carry out a number of long lead-time 'work-streams' in parallel before major capital investment can be made. In the case of Grain 3, these work-streams include the planning application, construction tender, open season and exemption application. Grain LNG believes the regulatory process should recognise and be supportive in light of these practical issues, particularly when the method adopted to sell capacity (which gives rise to some uncertainty regarding capacity allocation) is by its very nature, consistent with rTPA. To do otherwise could lead to a regulatory process being carried out in series, delaying construction start and potentially dictating the gas on stream date, rather than supporting the development in line with market preferences (e.g., for a 2010 gas on-stream date). It would also appear inconsistent with UK Government policy which is aiming to streamline the planning process so as not to delay the introduction of major gas infrastructure projects.

Grain LNG is appreciative of Ofgem continuing to support this parallel approach, which was also adopted in phase 2 of Grain and led to an Ofgem consultation process in which the identity of the successful capacity holders was similarly unknown. For the current consultation Grain LNG has provided additional information in the form of undertakings, something not provided for the Grain phase 2 rTPA exemption consultation. Consequently Grain LNG believes that, provided it has demonstrated and Ofgem by its own analysis has verified that, even in the worst case as provided for by the undertakings, the candidate LNG shippers cannot give rise to any foreseeable competition concerns, then respondents should not require further information on which to base their representations.

Competition Study

We would like to point out that exemption criteria (b) requires that the level of risk is such that the investment would not take place without the exemption. Grain LNG can confirm that the risk to itself as developer (and we believe to LNG shippers contracting for capacity) is such that it will not proceed with Grain 3 without an exemption. Therefore, in our opinion the appropriate counterfactual to be used in the competition assessment (condition (e)) if no exemption is granted, is that no Grain 3 capacity is built.

On this basis Ofgem's competition assessment (see Table A.3 of the consultation document) shows there to be reducing levels of concentration in the upstream gas market (in all market definitions analysed) for the scenario in which Grain 3 is constructed and granted an exemption compared to a background where it does not proceed.

Further, and in response to question 6 below, Grain LNG believes the relevant market is not that associated with the narrow definition of LNG importation. This is because LNG importers face competitive constraints on what they can charge within a competitive UK and European wholesale gas market. Due to its nature, LNG importation is a weak source of flexible gas with economic drivers limiting the amount of spare send-out capacity above contracted levels, limited tank space and ship arrivals dictating LNG withdrawals within a certain timeframe. Increased throughput over a prolonged period is not possible without impacting the whole LNG supply chain including production and shipping. The total number of berthing slots allocated to customers at Grain means there will be limited scope to accommodate an increased number of ships. This limited flexibility means LNG importation has a number of substitutes with which it competes: it is more akin to beach gas and interconnectors which have similar flexibility to respond to market conditions in the short term (as well as long range and mid range storage). Under this wider market definition (i.e. one that includes LNG, long and mid range storage and pipeline imports), the HHIs following the introduction of Grain 3 are reassuringly low at less than 800 indicating a competitive market (see Grain LNG's competition study in Appendix 7 of its application in addition to Ofgem's table A.3).

In summary, our formal exemption application demonstrates that Grain 3 passes all the relevant conditions for exemption, our approach is consistent with phase 1 and 2 of the development of Grain and the open season is consistent with rTPA. Grain 3 will come on stream in 2010 when numerous LNG shippers will be importing through a number of exempt LNG facilities and Grain 3 will be introduced in a manner consistent with the UIOLI arrangements in place at the time. Consequently, Grain LNG believes the granting of an exemption should not give rise to any concerns and will enable the Grain LNG facility to deliver further significant benefits to the UK and the EU in relation to security of supply and competition in the wholesale gas market.

We hope you find our consultation response helpful and we look forward to receiving Ofgem's final conclusions in respect of this matter. In the meantime, please do not hesitate to contact me should you require any further information.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Phil Carter', is positioned to the left of a vertical red line.

Phil Carter
Commercial Director
National Grid Grain LNG Limited

Appendix – Responses to Specific Questions

Question 1:

Do you agree with our overall assessment that the proposed exemption should be granted, based on the examination of whether each of the exemption criteria have been met?

Yes – based on the comments above and the analysis included in Section 7 of our application we believe the Grain 3 project meets the criteria required and should be granted an exemption.

Question 2:

Do you agree with the proposed duration of the exemption?

Yes - As noted in Section 8 of our application, Grain has requested an exemption of 20 years (or up to October 2029 at the latest) to provide the long term certainty in respect of the revenue it needs to fund the long payback period for the investment and commensurate with the risks involved. LNG Shippers also need certainty in respect of long-term access to importation facilities in order to underpin their major upstream investments. The duration requested is consistent with exemptions granted at other European LNG importation terminals including Gate LNG (20 years), South Hook (25 years), Dragon LNG (20 years), Fluxys LNG (20 years) as well as Grain 1 and 2 (20 and 25 years, respectively). It is also consistent with long term access arrangements necessary to underpin investment in, for example, the Viking Cable and I(UK) interconnector.

Question 3:

Do you agree that the proposed exemption should be subject to re-examination by the Authority, and if necessary to amendment or revocation, once the actual allocation of capacity through the open season process is known (particularly in the event that the outcome of the open season differs from that as represented by GLNG in its additional information and undertakings)?

No - As noted in the consultation document, for the purposes of Ofgem's competition assessment, Grain LNG provided additional information and undertakings relating to both the identity of bidders and the volume of primary Grain 3 capacity which they could acquire. Given this, the results of the Ofgem competition analysis concluded that there would be no competition concerns and that all the necessary conditions would be satisfied. Under its normal powers, Ofgem has the ability to review/revoke any exemption should it believe that the party holding the exemption no longer satisfies one of the necessary criteria, and Grain LNG believes that there should be no reason to re-open the exemption if all the conditions remain satisfied.

Notwithstanding the above, should Ofgem grant an exemption which remains conditional on the outcome of the open season process, Grain LNG requests Ofgem clarify under what circumstances it would expect to undertake such review. Indeed, without certainty that the exemption order will not be amended or revoked (or at least having a clear understanding under what conditions the exemption might be at risk), Grain LNG will be unable to commit to the considerable capital expenditure and LNG shippers may be unable to progress their upstream investment decisions, potentially delaying the Grain 3 gas 'on-stream' date.

Question 4:

Do you consider the competition assessment to be complete, and that it provides you with sufficient information on which to comment?

Yes - Given our comments in this letter regarding Ofgem's economic analysis and given that the results of both Ofgem's and our own competition assessments show no competition concerns, Grain LNG believes the competition assessment to be complete. Grain LNG also believes the economic information in both the Ofgem consultation document and the independent assessment that accompanies our application provides sufficient information to respondents on which to comment, as was the case with the Grain phase 2 exemption application.

Question 5:

Do you agree with the assumptions underlying our competition assessment, as outlined in Appendix 4?

Grain LNG has no specific observations on the assumptions made by Ofgem for the purposes of its competition assessment. Annexe 1 of appendix 7 of Grain LNG's application outlines the process followed by Frontier Economics for estimating the future position of parties in the UK wholesale market for its analysis.

Question 6:

Do you agree with our views on the definition of the relevant market? In particular, do you consider the flexible gas market remains the appropriate market definition for considering the effect on competition for the development of a new LNG importation facility?

As highlighted in the main body of this letter, Grain LNG agrees with Ofgem's observations outlined in paragraph 2.54 and paragraphs 1.30 to 1.32 of Appendix 1, i.e., a much wider market than that of LNG importation provides the appropriate definition for the purposes of the competition assessment.

Our own competition assessment considers in some detail all markets in which the Grain 3 expansion capacity could be considered to have either a direct or indirect impact. The analysis concludes with respect to the exemption that there is no relevant market in which Grain 3 (with rTPA exemption) would have a materially adverse impact on competition even if, in each market, the party with the highest market share in each market were to acquire exclusive rights to Grain 3.

Question 7:

Do you consider that there should be any additional conditions attached to the proposed exemption?

No - Developers and shippers alike need certainty on which to base investment decisions and additional conditions only introduce further regulatory uncertainty. As noted in our response to question 3 above, Grain LNG believes that any exemption granted in respect of the Grain 3 expansion capacity should only be subject to review by Ofgem should the actual Grain 3 capacity outcome not satisfy one of the conditions necessary for grant of the exemption.

Question 8:

Do you think that we should develop a guidance note on anti-hoarding arrangements to apply at LNG importation terminals?

To provide regulatory clarity and consistency of treatment across GB terminals, Grain LNG is supportive of Ofgem developing a guidance note on anti-hoarding arrangements to apply at LNG importation terminals. Notwithstanding this, Grain LNG notes the importance for such guidance note to be sufficiently detailed and sophisticated for example so as to take account of particular inherent market dynamics (i.e. since a 'one size fits all' approach may not be appropriate). Grain LNG also believes such guidance note needs to be developed through appropriate consultation with industry players and with LNG importers and terminal operators in particular. Grain LNG would be happy to participate in such consultation.