

SSE Hornsea Limited's application for an exemption from section 19B of the Gas Act 1986

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Target audience: This document will be of interest to gas storage facility operators and users, gas shippers, suppliers and other gas and electricity industry players.

Overview:

This document sets out for consultation Ofgem's initial view that an exemption should be granted to SSE Hornsea Limited ("SSEHL") for its share of the storage facility at Aldbrough. Such an exemption would relieve SSEHL of the obligation to offer third parties access to its share of Aldbrough storage facility on a negotiated basis.

The proposal to grant an exemption is based on Ofgem's understanding that there is effective negotiated third party access ("nTPA") at SSEHL's other storage facility (Hornsea). The existing nTPA arrangements at Hornsea have led us to conclude that nTPA to the Aldbrough facility is not required for the economically efficient operation of the GB gas market. We welcome respondents' views on this conclusion.

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Context

The Gas and Electricity Markets Authority (the "Authority") may exempt storage facilities from the requirements of negotiated third party access (nTPA) when it considers that third party access is not required for the economically efficient operation of the UK gas market. This provision is contained within Section 19A(6)(a) of the Gas Act 1986.

Ofgem welcomes further investment in gas storage facilities. Increasing gas storage capacity will help to manage peak winter demand and any shocks to gas supplies as peak winter production from the North Sea continues to decline.

Associated Documents

- Statoil UK Ltd's application for an exemption from section 19B of the Gas Act 1986, Ofgem Consultation, April 2007: <http://www.ofgem.gov.uk>
- SSE Hornsea Limited's request for an exemption from section 19B of the Gas Act 1986, October 2006: <http://www.ofgem.gov.uk>
- Statoil UK Ltd's application for an exemption from section 19B of the Gas Act 1986, November 2006: <http://www.ofgem.gov.uk>
- Decision on an application by WINGAS Storage UK Limited for an exemption under section 19A(6)(a) of the Gas Act 1986 from section 19B of the Gas Act 1986 for the proposed Saltfleetby gas storage facility, Ofgem, 30 August 2006. <http://www.ofgem.gov.uk>
- Decision on an application by Caythorpe Gas Storage Limited for an exemption under section 19A(6)(a) of the Gas Act from Section 19B of the Gas Act 1986, Ofgem, 5 July 2005. <http://www.ofgem.gov.uk>
- Decision on the proposed treatment under section 19A of the Gas Act 1986 of gas storage facilities with split ownership, 20 December 2005: <http://www.ofgem.gov.uk>
- National Grid Grain LNG Ltd application for exemption from Section 19D of the Gas Act 1986, Ofgem, 14 December 2006: <http://www.ofgem.gov.uk>
- Centrica plc and Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd: A report on the merger situation, Competition Commission, 2003. http://www.competition-commission.org.uk/rep_pub/reports/2003/480centrica.htm

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Summary

This document sets out, for consultation, Ofgem's initial view that an exemption should be granted to SSE Hornsea Ltd (SSEHL) for its share of the Aldbrough gas storage facility. Such an exemption would relieve SSEHL of the obligation to offer negotiated Third Party Access (nTPA) to its share of that facility. SSE Hornsea Ltd is a wholly owned subsidiary of Scottish and Southern Energy (SSE).

Background

In October 2006, SSEHL submitted an application under section 19A(2) of the Gas Act 1986 ("the Gas Act") requesting an exemption from section 19B of the Gas Act in relation to its share of the Aldbrough storage facility which is currently under construction in East Yorkshire.

The Aldbrough gas storage facility is a two-part facility with respective parts being owned by SSEHL and Statoil UK Ltd (STUK). On 13 February 2004, SSEHL and STUK signed a Joint Participation Agreement (JPA), which set out the ownership structure and detailed how the costs of both development and operation would be shared. All costs will be split on a one third to two third basis between STUK and SSEHL respectively. Capacity ownership will also be split on this basis.

In September 2005, Ofgem consulted on the treatment of split facilities under the Gas Act. In a letter dated 20 December 2005 Ofgem concluded that, where there are multiple owners of a facility, it is appropriate to accept exemption applications from more than one owner provided that effective operational separation is achieved.¹

This consultation document deals with SSEHL's application for an exemption from nTPA requirements in relation to its share of the Aldbrough facility. The consultation document for the STUK share of the Aldbrough facility was published on 3 May 2007².

According to SSEHL's exemption request, the SSEHL share of the facility consists of 3,033 GWh/annum (66.7%) of the total 4,550 GWh/annum of winter space with 281 GWh/day (66.7%) of deliverability, from a total of 421 GWh/day. SSEHL's share of the facility will be able to provide maximum deliverability for approximately ten days.

¹ Ofgem letter, Decision on the proposed treatment under section 19A of the Gas Act 1986 of gas storage facilities with split ownership, 20 December 2005, <http://www.ofgem.gov.uk>

² <http://www.ofgem.gov.uk>

Competition Assessment

Ofgem may grant an exemption from nTPA when the use of the storage facility by other persons is not necessary for the operation of an economically efficient gas market. In order to assess whether this criteria is met a competition assessment has been undertaken.

In this document we set out for consultation a range of different market definitions and scenarios for treating facilities subject to nTPA which we use in our competition assessment. The market definitions allow us to assess different substitutes for the Aldbrough facility. We welcome respondents' views on these different market definitions. These scenarios and market definitions have been developed as we recognise that there is more uncertainty today over the substitutes for a facility such as Aldbrough given the structural changes that are occurring in the GB gas market as it becomes a net importer of gas.

SSEHL's market position is different to STUK's as SSEHL already owns the Hornsea Medium Range Storage facility which is a direct substitute for Aldbrough storage. In addition, SSEHL's parent company SSE Energy Supply Limited (SSEESL) holds capacity at Hornsea.³ These factors make SSEHL's application more complicated to assess than STUK's. However, since Hornsea is subject to nTPA regulation it has not been included in our final assessment and SSEHL's market share. The effective functioning of nTPA at Hornsea is a key assumption underlying our analysis. We welcome views on this assumption.

Following this approach we consider that SSEHL's share of the relevant market(s) is sufficiently low for us to conclude that third party access to their share of Aldbrough is not necessary for the operation of an economically efficient gas market. Therefore, we are currently minded to grant an exemption to SSEHL in respect of its share of the Aldbrough gas storage facility.

Ofgem invites views on this consultation. Having considered respondents' views, we will set out our final decision on the exemption in a "Final Views" document.

³ SSEESL itself is owned by Scottish and Southern Energy plc ('SSE').

1. Introduction

→ Chapter Summary

This chapter outlines some background on the SSEHL Aldbrough storage facility and to the relevant legislation for granting an exemption. It also outlines the structure of the document and the way forward.

The Project

1.1. SSE Hornsea Limited ("SSEHL") is a wholly owned subsidiary of Scottish and Southern Energy plc ('SSE'). In September 2002, SSE completed the acquisition of Dynergy Hornsea Limited ('DHL'). As part of the transaction, SSE acquired the adjacent Aldbrough site, with the necessary planning consents for a six cavern gas storage facility.

1.2. In November 2002, Statoil (UK) Limited ("STUK") purchased the rights to develop a three cavern facility from Intergeren for an adjacent site to SSEHL's at Aldbrough. Given the proximity of the SSEHL and Statoil projects at Aldbrough and the high costs and risks associated with storage development, discussions took place to consider the possibility of sharing development costs to the benefit of both companies, whilst still maintaining the original rights to capacity.

1.3. It was agreed to split the costs of development and operation on a one third to two third basis between STUK and SSEHL respectively. Capacity ownership will also be split on this basis.

Facility specification

1.4. According to SSEHL's exemption request, the SSEHL share of the facility consists of 3,033 GWh/annum (66.7%) of the total 4,550GWh/annum of winter space with 281 GWh/day (66.7%) of deliverability, from a total of 421 GWh/day⁴. SSEHL's share of the facility will have the ability to provide a maximum deliverability for approximately 10 days (assuming STUK flow their one third share at the same time). The SSEHL facility has the ability to cycle nine times in a year (i.e. fill and empty) taking into account maintenance etc. However, this could be lower during physical operation subject to the operational regime at the time.

⁴ Note that SSEHL's quoted share of the facility differs slightly from that implied in the STUK consultation document due to handling of rounding errors in the two applications for exemptions. For the avoidance of doubt, this does not have a material impact on the analysis presented in this paper.

1.5. While STUK and SSEHL will have ownership of separate shares of the facility, they will utilise common above ground infrastructure. There will be one operator appointed to manage the facility. It has been agreed by the owners that the operator should be SSEHL. SSEHL has expertise and established infrastructure to manage the operations of a storage facility through its ownership and operation of the Hornsea gas storage facility.

1.6. SSEHL is a separate legal entity from SSE. There has been a legal separation policy put in place in respect of SSEHL's operation of the Hornsea Gas storage facility, in order to sell storage services to third parties. SSEHL will act as operator for the whole of the Aldbrough facility and offer a separated service for the operation of its two third share of the storage facility.

1.7. Up to three caverns are expected to come on line for commercial operation in winter 07/08, and thereafter the remaining caverns will be brought on line for operation in sequence. The division of capacity between the two parties will be constant following each phase of construction, with two-thirds of capacity to SSEHL and one-third to STUK.

Exemption application

1.8. Section 19(B) of the Gas Act 1986 (the 'Gas Act') requires that storage facilities are subject to negotiated Third Party Access (nTPA). Under the nTPA regime, parties must be able to negotiate access to storage facilities so as to conclude voluntary commercial agreements in that respect. Negotiations for access are to take place in good faith; where the owner and the applicant do not reach agreement on access to a facility, the applicant may apply to the Authority for directions which would secure that right. Further, storage facility owners are required to publish their main commercial conditions for the use of the facility system on an annual basis.

1.9. Under section of 19A(6)(a) of the Gas Act, a storage facility may be granted an exemption from the requirement to offer third party access if the use of the facility by other persons is not necessary for the operation of an economic and efficient gas market. Ofgem considers it appropriate to grant an exemption from third party access under this route only where the facility owner and the long term holder of the primary capacity at a facility has no appreciable market power. That is, where the party has such a weak position in the relevant market that it could only ever have an insignificant effect on the competitive conditions within that market. Ofgem will assess this on a case-by-case basis.

1.10. Both SSEHL and STUK have requested an exemption under section 19A(6)(a) of the Gas Act for their respective shares of Aldbrough by submitting two separate applications. Ofgem's decision letter of 20 December 2005⁵ regarding split ownership

⁵ Decision on the proposed treatment under section 19A of the Gas Act 1986 of gas storage

confirmed that such separate applications could be made. The applicants have indicated that their respective shares of Aldbrough will be operated as separate facilities. If anything came to light to suggest that this is not the way the facilities are being operated then Ofgem reserves the right to review the exemption (if granted).

1.11. If Ofgem decides to grant an exemption, then it will apply until it is revoked in accordance with its conditions. In particular, the Authority may revoke an exemption where it considers that the use of the facility is necessary for the operation of an economically efficient gas market; and the exemption may be revoked by the Authority with the consent of the facility owner. Ofgem will continue to monitor the market and will deal with any problems, if and when they arise.

Structure and approach

1.12. Chapter 2 of this document outlines Ofgem's definition of the relevant market in which the Aldbrough storage facility will operate. Chapter 3 presents Ofgem's market assessment based on this definition. The final chapter presents Ofgem's initial conclusions on this application, and invites further discussion. Appendices provide information on the consultation process, a glossary, an assessment of Ofgem's powers and responsibilities, a draft exemption order and an opportunity for interested parties to provide feedback.

facilities with split ownership, 20 December 2005: <http://www.ofgem.gov.uk>

2. Market definition

Chapter Summary

The chapter highlights Ofgem's approach to defining the market for flexibility and explores issues that arise in doing so. Ofgem's market definition analysis indicates that key substitutes for the Aldbrough medium range storage (MRS) facility include: MRS, Long Range Storage, IUK imports and potentially flexible beach gas supplies.

Question 1:

Do you consider our market definition is appropriate?

Question 2:

In particular do you consider the flexible gas market remains the appropriate market definition for considering the effect on competition of the development of a new medium range storage facility?

Introduction to market definition

2.1. Market definition is the first step of any competition analysis. It identifies the products which act as substitutes for each other, and it also provides the basis for calculating market shares. A market is defined through two dimensions: geographic area and product. For both dimensions, we need to start from the facility at hand, i.e. Aldbrough storage, and expand progressively to include products and areas which provide competitive constraints on the facility. Aldbrough falls within Ofgem's definition of a medium range gas storage facility.

SSEHL's proposed market definition

2.2. SSEHL has used a broad market definition including all gas and LNG storage facilities, beach swing, interconnector flows and interruptible demand contracts.⁶ SSEHL has calculated the current total market for winter space to be 552TWh/annum.⁷

2.3. SSEHL refers to previous Ofgem exemption decisions under section 19A(6)(a) of the Gas Act although there are some inconsistencies in SSEHL's analysis. For example, when SSEHL compares their share of the storage market with the

⁶ From SSEHL's application letter, p5, at <http://www.ofgem.gov.uk>

⁷ From SSEHL's application letter, p5, at <http://www.ofgem.gov.uk>

Saltfleetby decision, they use a different market definition for SSEHL's share of Aldbrough as compared to the market definition Ofgem used in Saltfleetby. However, the market share level at which an exemption was granted in this case is a relevant consideration.

Ofgem's view

2.4. In its 2003 Rough inquiry⁸, the UK Competition Commission defined the product sold by gas storage facilities as being flexibility and the relevant geographic market as being Great Britain. We adopt a similar approach to defining the relevant market concerning the Aldbrough storage facility.

2.5. Ofgem has assessed SSEHL's market shares within the flexibility market, in terms of their capacity holdings.

2.6. In line with the Competition Commission, we recognise that the product definition for gas flexibility is not straightforward. We also consider that, since there have been important evolutions in the GB gas market since 2003 and the Competition Commission's inquiry, it is appropriate to revisit the analysis for the product market definition.

2.7. Significant new gas import capacities came online during 2006/07 (e.g. the Langede pipeline and the BBL Dutch-UK interconnector), altering the supply and demand balance previously observed. To take account of the recent changes in the GB market, and in particular the coming on line of the BBL in November 2006, we have based our analysis on the period from the coming online of BBL up to the most recent data available to us (March 2007).

Sources of flexibility

2.8. Using the Competition Commission's approach in Rough as a starting point⁹ we have looked at a range of possible sources of flexible gas in the GB market. Following this methodology would therefore require us to begin our assessment of the product market by assessing the facility itself (i.e. SSEHL's share of Aldbrough storage facility), then expanding progressively to include other possible substitutes. In doing this we took account of the "SSNIP" test¹⁰, i.e. for each market we consider whether a hypothetical monopolist in that market could profitably impose a significant increase in prices for a sustained period. In accordance with this approach, we worked outwards from the narrowest market definition to find the first market definition that might enable the SSNIP test to be met.

⁸ Centrica plc and Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd: A report on the merger situation

⁹ *ibid*, pp116-118

¹⁰ Where SSNIP stands for a "Small but Significant and Non-transitory Increase in Price."

2.9. The characteristics of SSEHL's share of Aldbrough were described in Chapter 1 under the 'Facility specification' heading. These characteristics indicate that the facility constitutes a Medium Range Storage (MRS) facility. Medium-range storage (MRS) has been defined for the purposes of our analysis as storage facilities with capability to flow gas at short notice for up to two months. Such facilities tend to be run down in winter and filled up in summer. However, unlike Long and Short Range Storage (discussed below) cycling gas is more common with MRS, although the extent of this depends on the facility in question. Given that SSEHL's share of Aldbrough is a MRS facility MRS would be the smallest possible market we have to consider.

2.10. There are other sources of gas which have flexible characteristics. We have considered the following:

- Short Range Storage (SRS): storage facilities with the capability to start flowing gas at very short notice for duration of less than one week. These characteristics of SRS tend to mean it is used only in emergency situations. SRS seems highly flexible, but the very low injectability severely reduces its commercial capabilities. For example, some SRS facilities can deliver up to 200 GWh/day for five days but take over 400 days to refill. These facilities have also been referred to as liquefied natural gas (LNG) storage as mostly the gas is stored in the form of LNG.
- Long Range Storage (LRS): storage facilities with the ability to start flowing gas at short notice for a duration of more than 2 months. Rough is the largest facility of this type in Great Britain. These facilities tend to be run down in winter and filled up in summer.
- Interconnector UK (IUK): the Belgian-UK interconnector, which flows gas to and from Belgium. IUK demonstrates a high responsiveness to prices, and hence a developed flexibility. However, the pipeline has not been used to its full capacity over recent winters for long periods.
- Balgzand Bacton Line (BBL): the Dutch-UK interconnector, flowing towards the UK only. Since coming on-line in November 2006 the BBL has run essentially baseload, however, this has potential to act more flexibly in the future.
- LNG importation terminals: terminals offloading LNG vessels - currently limited to the Isle of Grain terminal (Phase1). Isle of Grain Phase 1 terminal has been running base load this winter, demonstrating no flexible response to price so far. However, we can expect LNG importation gas to behave differently in the next few years, when different LNG terminals will become operational.
- UK Continental Shelf (Beach) production: domestic offshore supply. UK Continental Shelf (UKCS) production is essentially base load. However, some fields - Sean and those delivering at the Barrow terminal - have been proven to offer flexible supply.
- Pipeline imports: Langeled and Vesterled import pipelines from Norway. These pipelines seem to run essentially base load, and variations in supply volumes

have not been seen as coupled with price. However, we may see pipeline imports behave differently in the next few years, as the UKCS declines further.

- Demand-side response: end-users respond to high demand by reducing consumption, freeing supply for other users. Demand-side response particularly from the power sector seems very flexible in response to high prices. We have not included this response in our market definition and therefore consider our analysis to be conservative in terms of the potential substitutes given its focus solely on the supply side.

Substitutability analysis

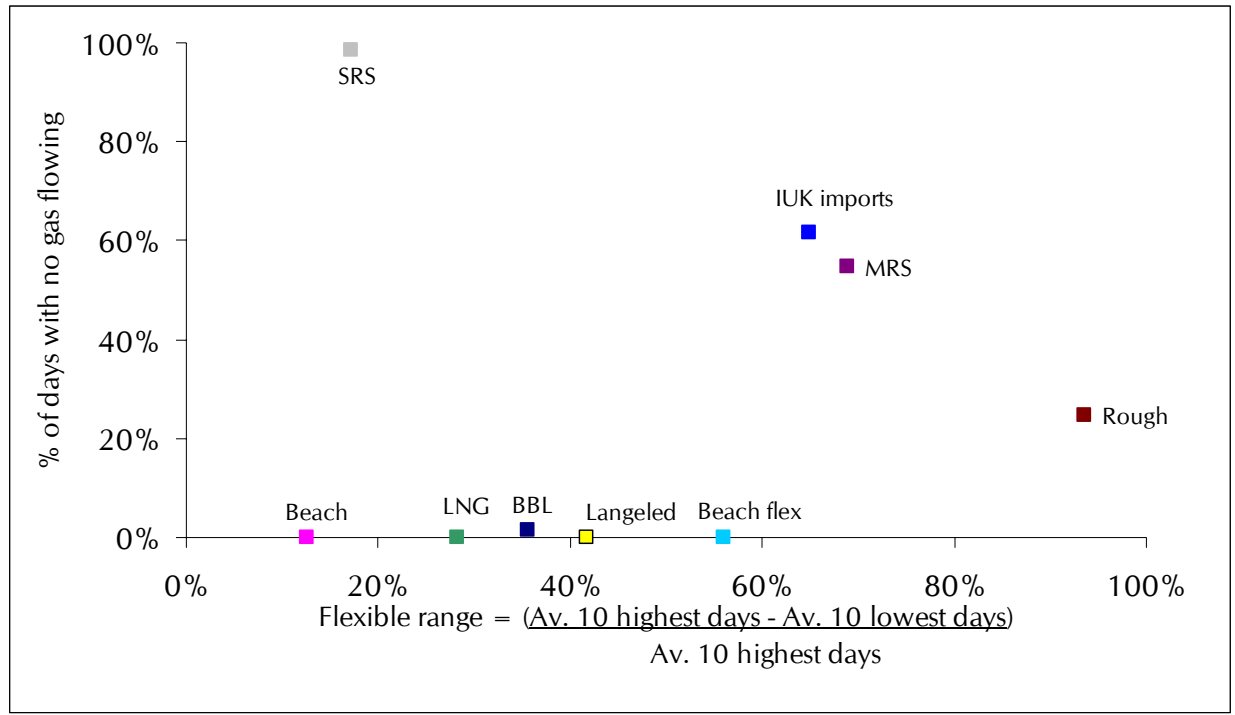
2.11. In order to identify the closest substitutes to MRS we have attempted to measure the relative flexibility of different sources of gas. We have developed two metrics to measure the degree of flexibility:

- Percentage of days when there was no gas flowing. This demonstrates ability to halt deliverability altogether, hence the existence of a non-base load component.
- Flexibility range: the variation between the highest deliverability days and the lowest ones. This demonstrates ability to flex the send-out.

2.12. The results are set out in Chart 1 below. The data set is flows of gas since the BBL came on-line in November 2006. Sources providing flexibility in the same region as MRS appear to include IUK imports, Long Range Storage¹¹ and Beach flexible supplies.¹² The flexible beach supplies are included because they have a high flexibility range, despite the fact that they do appear to flow gas every day.

¹¹ Rough being the only currently operational LRS facility

¹² Calculations have only been based on flows at Barrow terminal, in the absence of specific data for the Sean field.

Chart 1: Measuring the flexibility of gas supply

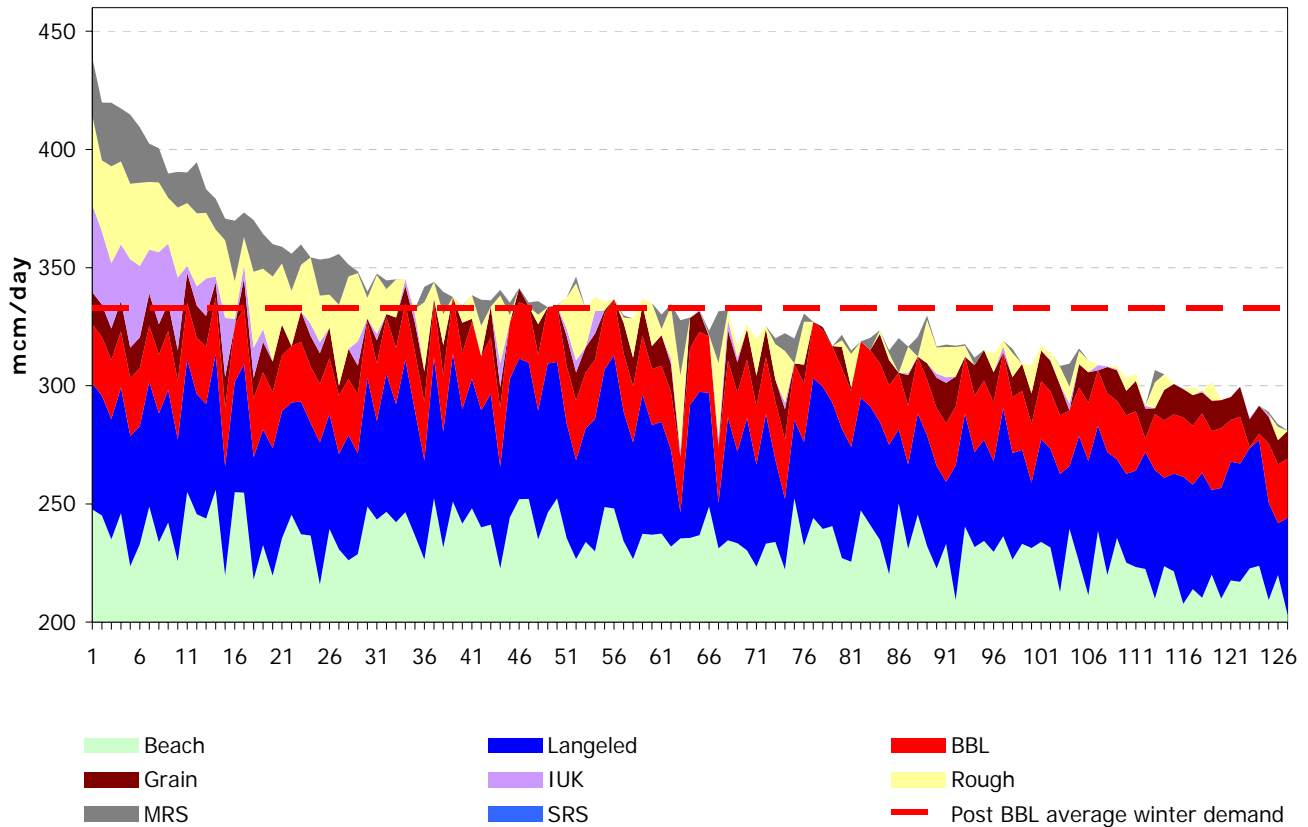
2.13. Chart 1 provides us with an approximate ranking for the sources of gas ranging from the highly flexible MRS and IUK imports to the base load beach supplies. This merit order has been used to derive a load duration curve (Chart 2 below).

2.14. The load duration curve ranks the highest to the lowest demand days of the winter on its horizontal axis, over the period from late November 2006 to March 2007. For each day it details the breakdown of supplies by source.

2.15. The horizontal line indicates the average daily demand over the period (25th November 2006 to 31st March 2007). The load duration curve supports the view that LRS and IUK provide similar levels of flexibility to MRS (given these sources tend to flow on the same highest demand days)¹³.

¹³ Due to data constraints we are unable to separate out the flexible beach sources from the data on beach supplies in Chart 2

Chart 2: Load duration curve: All demand days post BBL - 25th November 2006 to 31st March 2007



Market definition conclusions

2.16. The analysis presented in Charts 1 and 2 suggests that there are two potential appropriate market definitions for flexibility. These are:

- MRS+LRS+IUK
- MRS+LRS+IUK+Flexible Beach

2.17. We propose using both of these as the starting point for our market assessment (Chapter 3).

2.18. Flows through IUK represent a significant component of both these market definition scenarios. However, although IUK is highly flexible we note that its full capacity has not been exploited, even on days of peak winter demand. This may be due to constraints on the continent. Therefore, in our modelling we have calculated IUK capacity based upon National Grid's assessment of maximum winter outlook, at

40 mcm/day (433.2 Gwh/day)¹⁴. For the purposes of this assessment, flexible beach is measured at 440.781 Gwh/day, comprising flows from Barrow and the Sean field.

2.19. We invite views of respondents on our market definition conclusions.

¹⁴ From National Grid plc: Winter 2006/7 Consultation Document
<http://www.nationalgrid.com/NR/rdonlyres/2B485967-7100-41A8-882B-559DEC0BF508/10776/MainbodyWCR210906final.pdf>

3. Market assessment

Chapter Summary

In this chapter we conclude that Ofgem is minded to grant an exemption from Section 19B of the Gas Act to SSEHL for its share of the Aldbrough storage facility. The Chapter explores different possible treatments of facilities subject to Third Party Access (TPA). This is particularly relevant for SSEHL as it owns Hornsea storage facility which is subject to negotiated third party access (nTPA).

It is Ofgem's preliminary view that as Hornsea is subject to nTPA it may be excluded from our final assessment and from SSEHL's market share. The effective functioning of nTPA at Hornsea is a key assumption underlying our analysis. Under this approach SSEHL's share of the relevant market(s) is sufficiently low for us to conclude that TPA to the SSEHL share of Aldbrough is not necessary for the operation of an economically efficient gas market.

Question 3:

What is your experience of the functioning of Third Party Access (TPA) regulation in the GB market?

Question 4:

Should ownership of TPA facilities be included in the market share used in this assessment? Please provide detailed arguments.

Question 5:

Is it appropriate to exclude Hornsea from SSEHL's share of the market given that Hornsea is subject to nTPA?

Question 6:

Do you agree with our overall assessment that the proposed exemption should be granted?

Introduction to market assessment

3.1. As explained above in order for an exemption to be granted under Section 19A(6)(a) of the Gas Act, we need to ensure that the operation of the facility under an exempted regime could only ever have an insignificant effect on the competitive conditions within that market.

3.2. Although this assessment is not based on market shares alone, these do constitute a key indicator of market power. We also take into account other factors that may be important in the assessment of market power, such as the operating characteristics of the facility and how such a facility would be likely to be used.

SSEHL's proposed market assessment

3.3. SSEHL has calculated the current total market for winter space to be 552TWh/annum.¹⁵ Their application indicates that if SSEHL Aldbrough had been commissioned in November 2006 it would have added an additional 3TWh/annum and account for 0.5% of the winter space market. SSEHL calculates the current total market for daily 'flexibility' to be 5,200GWh/day. Again, if SSEHL Aldbrough had been commissioned in November 2006, SSEHL estimate that it would have added an additional 281GWh/day and would account for 5% of the 'flexibility market'.

3.4. SSEHL also conducts a forward looking analysis where they take account of known planned storage and LNG developments. SSEHL anticipates that Aldbrough's share of the winter space and daily 'flexibility' markets to be 0.4% and 4% respectively.¹⁶

3.5. Since Hornsea is already subject to regulated TPA, SSEHL do not believe that Hornsea should be grouped alongside Aldbrough.¹⁷

Ofgem's view

3.6. In the previous chapter, we defined the flexibility market to be used for our assessment. We considered the following market definitions to be the most appropriate:

- MRS+LRS+IUK
- MRS+LRS+IUK+Flexible Beach

3.7. Under both market definitions, a proportion of the flexibility market (namely Hornsea, Rough and IUK) is subject to Third Party Access (TPA)¹⁸, and as such is required to provide fair and competitive access to capacity to all market participants. The market share calculated for the assessment of this exemption is concerned with

¹⁵ From SSEHL's application letter, p5, at <http://www.ofgem.gov.uk>

¹⁶ *ibid*, p5, at <http://www.ofgem.gov.uk>

¹⁷ *ibid*, p6, at <http://www.ofgem.gov.uk>

¹⁸ Although most storage facilities are subject to negotiated third party access under Section 19(B) of the Gas Act other gas infrastructure, such as IUK and Rough are subject to slightly different third party access regulations.

the market position of SSEHL and whether its position could be considered to have an insignificant competitive effect. SSEHL owns the Hornsea storage facility. In addition, SSEHL's parent company, SSE Energy Supply Limited (SSEESL) holds a significant amount of the capacity at Hornsea. This makes the fact that Hornsea is subject to nTPA particularly relevant for this application. These factors also make SSEHL's application more complicated to assess than STUK's.

3.8. To present a full and complete analysis of the market shares held by SSEHL within the relevant market(s), we have run our analysis under three scenarios for the next three gas years. This approach takes into account the fact that some facilities are subject to third party access obligations ("TPA facilities"):

- a. **Applicant's total ownership** of TPA facilities to be included in the applicant's market share - e.g. 100% of capacity at Hornsea attributed to SSEHL
- b. **Applicant's parent company's current primary capacity holdings and predicted future holdings** at TPA facilities to be included in the applicant's market share. This means that a proportion of capacity at Hornsea is allocated to SSEHL in gas year 2007/08 and a proportion of capacity allocated to SSEHL thereafter, consistent with an estimate of SSEHL's capacity ownership¹⁹.
- c. **No capacity (zero ownership)** at TPA facilities to be included in the applicant's market share - e.g. 0% of capacity at Hornsea attributed to SSEHL.

3.9. We invite respondents' views on whether these scenarios cover the entire spectrum of potential treatment applied to TPA facilities.

3.10. Market shares in the different flexibility markets under the three proposed scenarios are represented in the following table:

Table 1: SSEHL Market Shares under various scenarios for treatment of TPA (Gas year 2007/08)

Market Definitions	Scenario "a"	Scenario "b"	Scenario "c"
1. MRS + LRS + IUK	18.9%	10-15%	6.1%
2. MRS + LRS + IUK + Flexible Beach	14.7%	5-10%	4.8%

¹⁹ Actual figures for these proportions are not included in this document at the request of SSEHL, on confidentiality grounds.

Table 2: SSEHL Market Shares under various scenarios for treatment of TPA (Gas year 2008/09)

Market Definitions	Scenario "a"	Scenario "b"	Scenario "c"
1. MRS + LRS + IUK	18.1%	10-15%	8.0%
2. MRS + LRS + IUK + Flexible Beach	14.7%	10-15%	6.5%

Table 3: SSEHL Market Shares under various scenarios for treatment of TPA (Gas year 2009/10)

Market Definitions	Scenario "a"	Scenario "b"	Scenario "c"
1. MRS + LRS + IUK	10.2%	5-10%	6.0%
2. MRS + LRS + IUK + Flexible Beach	9.3%	5-10%	5.5%

Scenario a: 100% of capacity at Hornsea attributed to SSEHL

3.11. This approach assumes that ownership of the facility gives full control to SSEHL. In effect, it does not take into account the fact that Hornsea is subject to nTPA. Under both market definitions for the next two gas years, the market share attained by SSEHL in this scenario might be considered to be outside that which would enable us to grant an exemption under section 19A(6)(a) of the Gas Act. However, this does not appear to be the most appropriate approach.

Scenario b: primary capacity at Hornsea attributed to SSEHL

3.12. There is significant uncertainty regarding the level of SSEHL's future share of primary capacity at Hornsea. However, largely based on historical data, Ofgem has calculated an estimate of this future shareholding²⁰. Our analysis of market shares under this scenario is illustrated in the tables above, and it is apparent that the decision regarding whether or not SSEHL should be granted an exemption under section 19A(6)(a) of the Gas Act in this scenario is highly dependent on the market definition.

3.13. On balance, we do not consider this scenario to be appropriate. There is considerable uncertainty regarding the level of SSEHL's holding of capacity at Hornsea, and we consider that basing SSEHL's share of the relevant market on SSEHL's capacity at a facility which is subject to nTPA is not appropriate. We discuss this issue in more detail below.

²⁰ This data has not been included in this document at the request of SSEHL, on confidentiality grounds.

Scenario c: 0% of capacity at Hornsea attributed to SSEHL

3.14. In this scenario we take the view that because Hornsea is subject to nTPA, SSEHL is unable to use its ownership of Hornsea to adversely influence the economic and efficient operation of the gas market. For this scenario under both market definitions, the market share attained by SSEHL is in our view so small as to be insignificant. Regulating such a share is unlikely to be "necessary for the operation of an economically efficient gas market". Under such circumstances, we would be minded to grant the exemption.

Treatment of TPA facilities

3.15. Applying nTPA regulation changes commercial conditions for access to capacity. This has been recognised by the Competition Commission in its assessment of the Centrica Rough merger case in 2003²¹. Specifically, one of the essential remedies recommended by the Competition Commission to prevent a weakening of competitive conditions was to impose on Centrica non-discriminatory commercial access to Rough capacity. Therefore, the provisions of nTPA remedies (imposed either by virtue of section 19B of the Gas Act or otherwise) are specifically designed to prevent the exercise of market power.

3.16. Consequently, there is a strong argument for treating TPA capacity differently from unregulated assets in calculating market shares for the purposes of our analysis.

Conclusion

3.17. Our initial view is that Scenario "c" is the most appropriate methodology to use to assess this exemption request. This is based on the assumption that nTPA regulation is working effectively at Hornsea. We would welcome respondents' views on this assumption.

3.18. Under both market definitions for Scenario "c" the market share attained by SSEHL is relatively small. Therefore, our current view is that access to SSEHL's share of the facility is not "necessary for the operation of an economically efficient gas market". We are therefore minded to grant the exemption to SSEHL.

3.19. However, we welcome views from industry participants, in particular on their experiences with nTPA regulation at storage facilities and how this works in practice. In addition, we invite views on whether ownership of TPA facilities should be included in the market share considered for an exemption under 19A(6)(a) of the Gas Act.

²¹ Centrica plc and Dynegy Storage Ltd and Dynegy Onshore Processing UK Ltd: A report on the merger situation: http://www.competition-commission.org.uk/rep_pub/reports/2003/480centrica.htm

3.20. In its application SSEHL indicated that the Aldbrough storage facility will be governed by robust Use It or Lose It (UIoLI) provisions, which will ensure that neither party can withhold unused capacity. SSEHL also indicated that any contracts will include provisions to guard against capacity hoarding and any capacity sold by SSEHL will be in accordance with non-discriminatory principles, ensuring that the facility is used to its maximum efficiency. Ofgem welcomes this approach.

3.21. For the avoidance of doubt, any views expressed, or decisions made, in respect of the giving of exemptions from section 19B of the Gas Act are expressed or made solely in relation to the relevant criteria for the giving of exemptions set out in section 19A. Any decisions that Ofgem may make, or view that Ofgem may express, in relation to this application for an exemption does not preclude or impact in any way on the operation of the Competition Act 1998 or the Enterprise Act 2002. Further, as the analysis contained in the document is in relation to a specific situation, the analysis may or may not necessarily be relevant to a consideration of any related issues that may arise, for example under the Gas Act, the Competition Act 1998 or the Enterprise Act 2002.

4. Process and way forward

4.1. Ofgem invites respondents' views on the questions outlined in the previous chapters in relation to the definition of the relevant market and our analysis concerning the applicant's market share. We will take such views into consideration when forming our final views.

4.2. Having considered respondents' views, we will set out our final views on the exemption application in a "Final Views" document. In the event that we conclude that an exemption is appropriate, this document will include the final exemption order.

Appendices

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Appendix 1 - Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 27 June 2007 and should be sent to:

Philip Davies
GB Markets
9 Millbank, London, SW1P 3GE
Email: GB.Markets@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to publish a Final Views document. Any questions on this document should, in the first instance, be directed to:

Emma King
GB Markets
9 Millbank, London, SW1P 3GE
Tel: 0207 901 7018
Email: emma.king@ofgem.gov.uk

CHAPTER: Two

Question 1:

Do you consider our market definition is appropriate?

Question 2:

In particular do you consider the flexible gas market remains the appropriate market definition for considering the effect on competition of the development of a new medium range storage facility?

CHAPTER: Three

Question 3:

What is your experience of the functioning of Third Party Access (TPA) regulation in the GB market?

Question 4:

Should ownership of TPA facilities be included in the market share used in this assessment? Please provide detailed arguments.

Question 5:

Is it appropriate to exclude Hornsea from SSEHL's share of the market given that Hornsea is subject to nTPA?

Question 6:

Do you agree with our overall assessment that the proposed exemption should be granted?

Appendix 2 – The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.²²

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly²³.

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them²⁴; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.²⁵

²² entitled "Gas Supply" and "Electricity Supply" respectively.

²³ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

²⁴ under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

²⁵ The Authority may have regard to other descriptions of consumers.

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- Promote efficiency and economy on the part of those licensed²⁶ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- The effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- The principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- Certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation²⁷ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

²⁶ or persons authorised by exemptions to carry on any activity.

²⁷ Council Regulation (EC) 1/2003

Appendix 3 – Draft 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 SSE Hornsea Limited²⁸, 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 Aldbrough, Garton, Hull HU11 4QB, subject to the attached Schedule.

Philip Davies
Authorised in that behalf by the

Gas and Electricity Markets Authority

Dated xxxxxx

²⁸ England No. 04467860. Registered Office: SSE Hornsea Limited, 55 Vastern Road, Reading, Berkshire, RG1 8BU

SCHEDULE
PERIOD, CONDITIONS, AND REVOCATION OF EXEMPTION

A. Interpretation and Definitions

In this exemption:

"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 SSE Hornsea Limited's share of the Aldbrough gas storage facility located at Garton, Hull, HU11 4QB
"facility owner"	means SSE Hornsea Limited in its capacity as owner of the facility
"facility operator"	means SSE Hornsea Limited in its capacity as operator of the facility

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

The capacity of the facility, being up to 3,033 GWh/annum.

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 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:

"information"	means information relating to the operation of the pipe-line system which is operated by a relevant gas transporter
"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 facility operator interfaces with as a system operator

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 (and as if the transferee was substituted in the definition of "facility" and "facility owner").

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 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 entered administration under section 8 of and Schedule B1 to the Insolvency Act 1986;

(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.

Appendix 4 - Glossary

B

Balgzand Bacton Line (BBL)

The Balgzand Bacton Line (BBL) is an interconnector that flows gas from Balgzand in the Netherlands to Bacton in the UK. It currently transports gas only in one way: from the Netherlands to the UK.

Beach swing

Beach swing refers to the variability in GB supplies from the UK Continental Shelf due to commercial motivations.

Base load

Part of the gas supply that is flowing on most days, and prone to only small variations.

C

Cycling

Successive injection and withdrawal of gas within a short period of time at a storage facility. Cycling usually refers to multiple successive refill and withdrawal cycles within the winter, as opposed to a unique summer refill followed by winter withdrawal.

D

Deliverability

Storage exit capacity - i.e. from the storage facility to the transmission system

Duration

Number of days a storage facility can flow at maximum deliverability (without injection).

G

Gas storage

Any facility designed to take gas (inject) from the NBP and release it (deliver) at a latter moment.

One distinguishes between Short, Medium and Long range facilities according to the length of time during which the facility can theoretically deliver gas from its maximum stock at full capacity:

- Short Range Storage (SRS): Up to 5 days
- Medium Range Storage (MRS): Between 5 and 70 days
- Long Range Storage (LRS): More than 70 days

I

I&C interruption

Some Industrial and Commercial (I&C) customers have signed supply contracts providing for cut-offs at the discretion of the gas supplier. Thus, I&C interruption refers to the flexibility brought by this option to cut demand.

Injectability

Storage entry capacity - i.e. from the transmission system to the storage facility

Interconnector

An interconnector is a pipeline linking two consumption markets, as opposed to pipelines linking a gas field and a consumption market.

Interconnector UK (IUK)

Commercial name of the interconnector linking Belgium and Great Britain.

L

Liquefied Natural Gas (LNG)

The fluid state of natural gas. It can be obtained industrially by cooling down natural gas. Used essentially in dedicated tanker ships to transport gas over seas in a much reduced volume.

Long Range Storage (LRS)

See Gas storage

Langeled

Underwater pipeline bringing gas from Norway (Ormen Lange) to the UK (St Fergus)

M

Medium Range Storage (MRS)

See Gas storage

N

National Balancing Point (NBP)

The virtual unified trading point of the GB gas transmission network

R

Rough

A long-range offshore gas storage facility, located off the east coast of England.

S

Short Range Storage (SRS)

See Gas storage

Small but Significant Non-transitory Increase in Price (SSNIP) test

A SSNIP test considers if a hypothetical monopolist on the considered market, defined as a couple of products and regions, could profitably increase prices by 5-10%.

Series of SSNIP tests are used by National and Community Competition authorities to define precisely and robustly which couple of products and regions forms the applicable market. Determining the correct product/region couple stems from iterative and broadening application of SSNIP tests: the narrowest product/region couple passing the SSNIP test (i.e. permitting a profitable 5-10% increase in price by a hypothetical monopolist) is the relevant market.

T

Tampen

Underwater pipeline bringing gas from Norway (Stratfjord) to the North Sea UK pipeline system (FLAGS)

Appendix 5 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand, could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?
6. Please add any further comments?

1.2. Please send your comments to:

Andrew MacFaul
Consultation Co-ordinator
Ofgem
9 Millbank
London
SW1P 3GE
andrew.macfaul@ofgem.gov.uk