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customer representatives,
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Dear Colleague

Preliminary views on the Third Party Access regulatory regime for gas storage facilities in the GB market

In September 2009, the Third Package, which for the purposes of this letter means the Gas Directive¹ and the Gas Regulation,² came into force. The Second Package³ which provided the basic framework for negotiated Third Party Access ("nTPA") to gas storage in the GB market will be repealed by the Third Package when it applies from March 2011.

From 3 March 2011, storage system operators ("SSOs") will have an obligation to comply with the directly applicable provisions of the Gas Regulation and the relevant provisions of the Gas Directive, as transposed into domestic legislation. The Gas and Electricity Markets Authority ("the Authority")⁴ will be responsible for ensuring general compliance with requirements of the Gas Regulation and of the Gas Directive once it has been transposed into domestic legislation.⁵ Further to our general duty to ensure compliance, Ofgem also has a specific enforcement role where there is a dispute regarding third party access to storage under sections 19B(8) of the Gas Act 1986 ("the Gas Act") and 17D(8) of the Petroleum Act 1998 ("the Petroleum Act").

Member States have some discretion in relation to how the provisions of the Gas Directive are transposed into domestic legislation. Market participants have raised queries regarding how Ofgem may be minded to interpret certain key provisions of the Third Package and have suggested that this uncertainty has implications for their investment decisions. In response to these queries, Ofgem has committed⁶ to publishing guidance on the matters that we may consider in relation to compliance with relevant legislation for access to gas

¹ Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC ("Gas Directive").

² Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 ("Gas Regulation").

³ For the purposes of this letter the term "Second Package" is used to refer to 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 and to Regulation (EC) No 1775/2005 of the European Parliament and of the Council of 28 September 2005 on conditions of access to the natural gas transmission networks.

⁴ Ofgem is the office of the Authority. The terms 'Ofgem' and the 'Authority' are used interchangeably in this letter.

⁵ The Department of Environment and Climate Change (DECC) is primarily responsible for the transposition of the Gas Directive. DECC has indicated that it intends to designate Ofgem as the national regulatory authority under the Third Package. However, as the enforcement provisions of the Gas Regulation need to be transposed into domestic law, Ofgem is waiting to see how the Government proposes to transpose these provisions.

⁶ Corporate Strategy and Plan 2010-2015, Ofgem March 2010 (46/10)

<http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/Corporate%20Strategy%20and%20Plan%202010-2015.pdf>

storage facilities; and measures that SSOs could adopt in order to reduce the risk of non-compliance, including in the case of a dispute over access.

This letter forms part of our commitment to provide guidance and sets out our preliminary views in relation to compliance with the provisions of the Gas Regulation pertaining to (a) storage capacity allocation mechanisms; (b) contract length and service specification; and (c) issues associated with transactions with related undertakings.

Ofgem currently intends to publish a consultation on its guidance on the matters covered in this letter as well as other aspects of the Third Package related to third party access to storage facilities. We intend to publish this consultation once the Government decides how it proposes to transpose the Third Package into national legislation.⁷

This letter highlights our preliminary views of some of the issues to which the Authority is likely to have particular regard when considering compliance with the legislation relating to access to storage, it is by no means definitive or exhaustive. The objective of this workstream is to provide general guidance to SSOs and storage facility users. However, we will consider each case on its merits.

Background

The current access requirements for gas storage facilities flow from Article 19 of the Second Package gas directive. In the GB market, the default access regime for storage facilities is that they are operated under nTPA compliant arrangements.⁸

Under Article 19(3) of the Second Package gas directive, where a Member State has chosen nTPA, it is required to take the necessary measures for natural gas undertakings (industry participants but not final customers) and eligible customers either inside or outside of the interconnected system to *"...be able to negotiate access to storage...when technically and/or economically necessary for providing efficient access to the system"*.

Under section 19B of the Gas Act and section 17D of the Petroleum Act, the owner of a storage facility is required to publish its main commercial conditions at least once a year, negotiate in good faith and endeavour to reach an agreement with an applicant for capacity. The conditions published are required not to discriminate against any applicants or descriptions of applicants.⁹

Under the Third Package¹⁰ (as under the Second Package), Member States may choose either negotiated or regulated third party access or both. In 2004, following a public consultation on the Second Package, the Government decided to retain the nTPA regime for gas storage facilities. Given this, Ofgem expects that the nTPA regime will continue in GB following the transposition of the Third Package.

⁷ DECC published a "call for evidence" published on 1 April 2010. This includes a consideration of third party access for gas storage facilities (section 4.10).

http://www.decc.gov.uk/en/content/cms/consultations/eu_energy_mkt/eu_energy_mkt.aspx. The initial call for evidence will be followed by an in depth consultation in the summer setting out where the GB market meets the requirements of the Third Package, and how to implement new measures.

⁸ The nTPA requirements are set out in s.19B of the Gas Act and s.17D of the Petroleum Act. Broadly, the storage provisions in the Gas Act cover onshore facilities whilst the Petroleum Act sets out requirements for off-shore facilities.

⁹ In certain circumstances, an SSO will not be required to offer nTPA at a specific facility. This may be due to the facility not being considered technically and/or economically necessary for providing efficient access to the system for the supply of customers. In such circumstances a Minor Facility Exemption can be sought from the Authority. Such exemptions can be granted under s.19A (6)(a) of the Gas Act and s.17C (5A)(a) of the Petroleum Act. Exemptions for major new gas storage facilities can also be considered under s.19A(6)(b) of the Gas Act and s.17C(5A)(b) of the Petroleum Act.

¹⁰ Article 33 of the Gas Directive.

The Third Package introduces a number of additional requirements for the access regime for gas storage that will apply to the GB market. These include:

- strengthening provisions to prevent discrimination in respect of TPA to storage facilities;
- requiring the unbundling of SSOs from vertically integrated companies;
- increasing information provision and transparency requirements; and
- enhancing monitoring duties and enforcement powers of the national regulatory authority.

In relation to the implementation of the Third Package, a significant change from the Second Package is that the Gas Regulation provides increased direction regarding the:

...basic principles and rules regarding network access, third party access services, congestion management, transparency, balancing and the trading of capacity rights. (Preamble, recital (4))

Purpose of guidance

The Third Package sets out a number of rules that are intended to ensure that SSOs provide third party access on an objective, transparent and non-discriminatory basis. SSOs must develop access arrangements that are compliant with the Gas Regulation and relevant provisions of the Gas Directive, as transposed into domestic legislation. Ofgem's guidance is intended to assist SSOs in developing their access arrangements to ensure that they are compliant with the Gas Regulation and to provide the market with direction as to the matters we are likely to consider in the case of a dispute.

In addition, Ofgem is of the view that SSOs and any related undertakings¹¹ (hereafter referred to as market players) with significant market power are more likely to be able to discriminate and restrict access to storage to an extent that it could have detrimental effects on consumers. We consider that this possibility places such market players at greater risk of being found in breach of the regulatory requirements. Given our additional concerns regarding market players with significant market power, we intend our guidance to provide additional details as to further safeguards that we would generally expect such market players should adopt when designing their access arrangements.

Assessing significant market power

Significant market power is usually defined as the ability of an undertaking to sustain prices significantly above some competitive level in a profitable way. Market power may also have a vertical aspect, which is the ability of vertically integrated undertakings¹² to affect competition in related markets.

In relation to gas storage, both of these matters can be reduced to the key concern of whether a market player, which may be vertically integrated in the related activities of gas production, gas shipping, and/or gas supply, can use its control over access to storage facilities to manipulate the wholesale price of gas.

More specifically, significant market power in the gas market could manifest itself in a market player withholding some of its storage capacity from the market in order to raise

¹¹ Related undertakings are defined in Article 2 (22) of the Gas Directive.

¹² Under Article 2(20) of the Gas Directive a 'vertically integrated undertaking' means a natural gas undertaking or a group of natural gas undertakings where the same person or the same persons are entitled, directly or indirectly, to exercise control, and where the undertaking or group of undertakings perform at least one of the functions of transmission, distribution, LNG or storage, and at least one of the functions of production or supply of natural gas.

peak gas prices and/or reduce off-peak prices. Alternatively, a vertically integrated market player holding significant market power, in the absence of effective safeguards, could hinder other market participants' access to storage so as to partially foreclose or increase barriers to entry in the downstream market by raising its rivals' costs.

In the energy markets, pivotality analysis is commonly used as a method of assessing the ability of a market player to manipulate prices. In relation to gas storage, a market player will be considered pivotal if market demand for flexibility cannot be met without the deployment of that player's supply sources (including storage). Ofgem considers that such analysis should take account of the degree of substitutability of different supply sources over different timeframes.

In case of a dispute over access, Ofgem would therefore generally expect to use pivotality analysis in the gas flexibility market as the primary basis for assessing the level of market power held by market players. Ofgem currently intends to consult on our approach to assessing significant market power.

The aim would be for market players to be able to use the same approach to self assess their own level of pivotality in order to consider the additional safeguards in our guidelines when designing their access arrangements.

Guidance on compliance, preliminary views

(a) Capacity allocation

The main requirements relating to capacity allocation are set out in Article 17 of the Gas Regulation. Under this article, SSOs are required to make the maximum storage facility capacity available to market participants, taking into account system integrity and operation. SSOs are also required to implement and publish non-discriminatory and transparent capacity-allocation mechanisms, which provide appropriate economic signals for the efficient and maximum use of capacity and facilitates investment in new infrastructure.¹³

In addition, under Article 15(a) of the Gas Regulation SSOs are required to offer services on a non-discriminatory basis to all network users that accommodate market demand; offering the same services to different customers under equivalent terms and conditions.

In cases where access to storage is congested and capacity is scarce, auctions allocate capacity more efficiently and provide more efficient economic signals for investment compared to other allocation mechanisms, such as first come first served arrangements. Further, auctions are more transparent and provide a lower likelihood of discrimination than other allocation mechanisms.

Given the above, Ofgem would generally expect SSOs to use auctions to allocate standard services. Further, in order to ensure the maximum efficient utilisation of capacity we would generally expect that the SSO sets the reserve price for the auction based on the relevant marginal cost reference.¹⁴ However, Ofgem recognises that other allocation mechanisms may also be appropriate in cases where significant market power is not a concern, physical capacity is not scarce or where non-standard services are being offered.

In addition to ensuring that the maximum capacity is made available, SSOs must also be aware of their obligations under Article 17(3) of the Gas Regulation to have measures in

¹³ The capacity-allocation mechanism must also be compatible with market mechanisms including spot markets and trading hubs, while also being flexible and capable of adapting to evolving market circumstances; and compatible with the connected network access system.

¹⁴ Ofgem's preliminary view is that the short run avoidable cost should be used for short term services; and the long run marginal cost should be used for long term services.

place to prevent capacity-hoarding.¹⁵ Further, under Articles 17(3)(b) and 22 of the Gas Regulation, SSOs also have an obligation to facilitate secondary trading of capacity purchased on the primary market.

(b) Contract length and service specification

Article 15 of the Gas Regulation sets down the requirements associated with the services that all SSOs must offer to the market. In particular, SSOs must offer firm and interruptible services, long and short term services, and bundled and unbundled services of storage space, injectability and deliverability. In relation to these requirements, a number of market players have requested guidance on the mix of long and short term contracts that they may be required to offer.¹⁶

Market participants require access to a mix of long and short term services. Short term contracts allow market participants to enter and adjust their portfolio of flexible gas supply, while long term contracts provide greater security and certainty.

Ofgem would generally expect SSOs to use appropriate, transparent processes to test market demand regarding the mix of services they provide. We would generally expect market demand to be tested whenever an SSO is offering new or additional capacity or services, when SSOs are considering significant changes in the mix of services they intend to offer, or when there is a significant change in market conditions.

Further, Ofgem would generally expect that the level of market testing performed by the SSO will be more extensive in cases where the decision of the SSO to alter its mix of services could result in a significant change to the mix of long and short term services currently offered in the GB market (i.e. a high proportion of services being offered on a short term basis).

In cases where SSOs intend to use long term contracts to underpin new investments, Ofgem would generally expect that the SSOs consider ways to ensure that the capacity is made available to the market on a non-discriminatory basis (for example, via auctions or open season procedures). In addition, Ofgem would generally expect that the maximum length of contracts offered to underpin new investments is consistent with a reasonable payback period for the investment. In order to comply with the Gas Regulation, a proportion of capacity should also be offered on a short term basis.

In such cases, we would also generally expect the SSO to be able to demonstrate that it has effective arrangements in place to facilitate the secondary trading of capacity such that capacity allocated on long term contracts in the primary market can be traded or offered on a short term basis to other parties. Similarly, we would generally expect the SSO to be able to demonstrate that its anti-hoarding arrangements ensure that unused capacity is made available on the primary market.

Ofgem intends to provide further details regarding our views on testing market demand, facilitating secondary trading of capacity and anti-hoarding arrangements in the consultation document we currently plan to publish.

c) Issues associated with transactions with related undertakings

Articles 15 and 17 of the Gas Regulation require SSOs to implement non-discriminatory capacity allocation mechanisms. This provision does not differentiate between related and non-related undertakings.¹⁷ Given this, undertakings should only be able to obtain services directly from a related SSO via the SSO's primary allocation mechanism.^{18,19}

¹⁵ Under Article 17(3)(a) of the Gas Regulation, SSO shall offer unused storage capacity on the primary market without delay; for storage facilities this shall be at least on a day-ahead and interruptible basis.

¹⁶ In relation to gas storage Ofgem views short term contracts as being of a duration of one year or less.

¹⁷ The Gas Directive (Article 15) sets down provisions which are intended to strengthen the unbundling of the SSO from the other part of a vertically integrated undertaking. Article 13(b) of the Gas Directive, SSOs should not

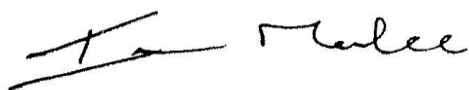
In the case of market players with significant market power, these could have the ability to discriminate or restrict access, and there is a risk that sales to related undertakings could be used as a means of withholding capacity in order to manipulate prices of wholesale gas. Given this, Ofgem would generally expect market players with significant market power to limit the proportion of storage services that are retained within such undertakings. Our current view is that the limit could reflect the undertaking's need for flexible gas supplies based on its customer portfolio.

Way forward

Ofgem currently intends to further develop these preliminary views and to consult the market on these and other issues associated with access arrangements for gas storage facilities once DECC has further clarified its position on the implementation of the Third Package.

If you would like to discuss any aspects of this letter or access arrangements for gas storage more widely, please contact Giuseppina Squicciarini (Head Regulatory Economics, GB Markets) at Giuseppina.Squicciarini@ofgem.gov.uk or Antony Miller (Senior Economist, GB Markets) at Antony.Miller@ofgem.gov.uk.

Yours sincerely



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discriminate between any users, particularly in favour of related of its related undertaking. DECC is responsible for transposing these provisions into GB legislation. Given this, Ofgem is not in a position to comment on the unbundling arrangements for SSOs.

¹⁸ Reserving capacity for related undertakings could be considered a form of discrimination in favour of the SSO's related undertakings.

¹⁹ Relating undertakings could also purchase the services of the related SSO via the secondary market.