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25 November 2011

Dear Francesca,

RE: Consultation on the regulated Third Party Access regime for LNG facilities in GB

This response to the above consultation is provided by the Centrica Group of companies excluding Centrica Storage Limited. We do not regard the information contained within this response as being commercially confidential and are happy for it to be published in the Ofgem library.

Centrica believes that the approach of offering rTPA exemptions to new LNG importation terminals has been a significant factor in the sizeable and rapid development of new LNG importation terminals in GB. This expansion in import capacity will have had a beneficial effect directly on consumers, by facilitating access to lower price gas supplies in the form of imported LNG, as well as inherently increasing GB's supply security position. Conversely, we believe that rTPA facilities simply would not be cost effective or efficient in the current market. Building an rTPA facility would be likely to be unprofitable and simply add cost to the UK consumer.

Q1. What level of consultation should an LNG system operator undertake when developing its main commercial conditions for the first time or when proposing amendments to its standard terms and conditions?

A1. The level of consultation should, as far as possible, be commensurate with the extent of the changes proposed. For example, for new facilities and significant changes to services offered, it would seem appropriate for any consultation to carry a full description of the services on offer, the cost associated with them (to the extent that this is known and available), capacities, durations, ways of expressing an interest or applying for the services, and significant terms and conditions. A minimum of 2 months should be allowed for responses.

For more minor changes, shorter durations of consultation may be appropriate whilst still providing all interested parties the opportunity to comment or seek further details on the proposed changes.

The competitive nature of LNG importation also serves to limit the extent of consultation which is needed. The competitive nature of LNG buying will ensure that the terminal offers a service which is

attractive to prospective users. Consultation is only needed to give potential users the opportunity to describe what type of service they need. Amendments to a service must not change existing users rights, risks and costs without the agreement of those customers. It is important that only users with current capacity rights have the right to negotiate a change. If the right is extended to all signatories then a beneficial change could be hindered.

Q2. Should an LNG system operator be expected to formally consult or test the market before changing existing services or offering any new services to the market? If no please provide your reasons.

A2. As above, the extent of consultation should be commensurate with the level of change. Where doubt exists about potential impacts, we would expect Ofgem to offer guidance to the rTPA facility operator on the appropriate extent of any consultation exercise.

If sufficient unused capacity is available in the UK then competition for cargos should provide sufficient incentive for the operator to provide reasonable conditions, so long as the operator has incentives to land LNG cargo. Excessive consultation will simply slow down the responsiveness of a terminal to market demands and could enable third parties to hinder a terminal's competitiveness.

However, we believe it might be appropriate to mandate consultation prior to the withdrawal of established services.

Q3. Do market participants have any concerns with our preliminary views on capacity allocation?

A3. Highest bid capacity allocation is an adequate method for allocation where the capacity is in demand. In the current situation where regas capacity is not in demand then the terminal will be unable to secure sufficient income to fund the large financing costs. This will lead to capacity build lagging behind demand and could cause a short term shortage in capacity.

We are surprised that Ofgem takes the view that it is not necessary to release information about reserve prices to all market participants. On the contrary we believe that information about reserve prices is essential to allow potential bidders to develop bidding strategies. It is not clear why this information should only be of interest to Ofgem.

The other major issue with the capacity allocation mechanism is aligning the lead time and duration of capacity reservation with the mechanics of the global upstream LNG market. Currently at least 90% of the LNG market is under long term contract and a higher proportion of LNG cargos are hedged into sales contracts, often with fixed destinations. The allocation mechanism and duration of capacity reservation will need to align to the timescales for the purchase of longer term LNG supplies. Shorter term and short notice bookings will cause the terminal to be only used for spot cargo purchases. The limited attractiveness of GB for LNG suppliers (due to the NBP price) means that availability of spot cargos is uncertain. A terminal which relies on spot cargoes is a very risky investment decision. In summary, arrangements should be flexible enough to support both long and short term requirements.

Q4. Can the Use It Or Lose It (UIOLI) arrangements implemented by LNG system operators in GB be improved to ensure greater utilisation? What lessons can we learn from current models to encourage greater use under an rTPA regime?

A4. The UIOLI mechanisms are in place to ensure that LNG capacity holders are unable to artificially inflate the UK wholesale gas price by preventing LNG being imported into the UK. This scenario could only arise if UK wholesale gas prices rise above the world LNG price and sufficient LNG could be attracted to the UK to utilise all capacity.

There are a great number of challenges with offering “under-utilised” capacity to potential users. These include significant considerations of safety, quality, liabilities, costs, and entitlements. Secondary users must also ensure that sufficient capacity is available in storage tanks (and where this isn’t the case, arrangements need to be in place for creating the required space and possibly compensating other affected users), as well as transmission system entry capacity. For these reasons, and because of the limited attractiveness of the GB market as an LNG destination at present, as set out above, the existing primary purchase, secondary capacity and UIOLI mechanisms haven’t had the opportunity to be tested. There are therefore limited lessons to be learnt from experience so far.

Current primary capacity holders are incentivised to fully utilise their capacity entitlements by bringing LNG to the UK to offset the large cost of regasification capacity. When UK market price rises sufficiently to attract LNG to the UK then we expect current capacity holders to remain competitive in securing LNG supplies. While this level of competition continues then the primary purchase route to the UK market will remain the most efficient and attractive to sellers.

Centrica has worked hard with Ofgem and other stakeholders in order to develop secondary market procedures which facilitate the use of “spare” LNG terminal capacity to the fullest possible extent and believe that the arrangements we have put in place represent the best possible way of managing this capacity. We have never been approached by an LNG seller who wished to use the secondary mechanism so are unable to offer any views on its effectiveness.

Ofgem needs to carefully consider the possible unwanted results of using an “improved” mechanism for rTPA facilities. A mechanism which could enable LNG sellers to access firm capacity at very low cost will prevent prospective facility owners from receiving sufficient tariff to justify investment. It would also undermine the ability of all current LNG importation capacity holders to negotiate and secure longer term firm supplies.

Q5. Do market participants have any views on why secondary capacity trading has been so little used? Is access to unused capacity happening through mechanisms other than secondary trading and/or UIOLI arrangements?

A5. Secondary capacity transactions may be confidential between the current users of exempt terminals and we cannot therefore comment on the overall extent of secondary capacity trading. Secondary capacity trading – that is, trading of primary capacity between existing primary capacity holders - is currently very active between the users of the Isle of Grain, where Centrica is a capacity holder. There is also public evidence of non-primary capacity holders “pre-qualifying” for the use of spare capacity at South Hook.

With respect to our own capacity, we believe the most straightforward and effective solution for third parties to access spare capacity which we may have available is by direct sale and purchase of LNG cargo. Using this method a LNG cargo seller is able to avoid the multiple risks, contractual arrangements and additional costs needed to get a cargo into the NBP.

The current lack of LNG available to the UK market is causing existing capacity holders to be highly competitive for any available cargos. This level of competition leaves little to no margin available for third parties to invest in the people and systems needed to trade LNG into the UK market. It therefore does not make commercial sense for a secondary user to import an LNG cargo using a secondary capacity mechanism.

Q6. Are there any mechanisms that could be established to facilitate greater use of secondary trading arrangements?

A6. As set out above, under the current market conditions there is no demand for secondary capacity beyond trading between existing primary capacity holders. Further, we are not aware of any LNG

cargos which have wanted to come to GB but have been unable to. It may be that Ofgem might wish to conduct further research on this point prior to concluding that current arrangements are deficient. We continue to believe that the arrangements we have in place continue to represent best practice with regards to facilitating maximum utilisation of any spare LNG terminal capacity over which we have primary rights, although they are not being used.

A new rTPA facility must have separately tradable slots, space, deliverability and ballasting capability for trading to be beneficial. Separation of the capacity types enables users to realise incremental value from each, or package them together into a full importation package.

Q7. In addition to the information detailed in this chapter, is there any further information that LNG system operators should make publicly available?

A7. None additional, that we are aware of.

Q8. To what extent do you consider that market participants will be able to observe non-compliance with the legislative requirements by an LNG system operator?

A8. It seems likely that the parties best placed to observe non-compliance are those who are unable to land a cargo despite following established processes, guidelines etc. Clearly if this were to be the case, we would expect such matters to be brought first to the attention of the counterparty, and reasonable attempts made to resolve the problems through negotiations. Failing this, Ofgem may wish to hear disputes and undertake a dispute resolution role.

Q9. Taking into account your answer to question 8, what (if any) additional information to that set out in the previous chapter should LNG system operators provide to the authority?

None.

Please don't hesitate to contact me if you would like to discuss any aspect of this response.

Yours sincerely,

Chris Wright
Commercial Manager