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all gas and electricity customers*

LNG facility operators, primary  
capacity holders, shippers,  
upstream and downstream  
market participants and other  
interested parties

Date: 8 March 2013

Dear Colleagues,

**NATIONAL GRID GRAIN LNG'S APPLICATION FOR AN EXEMPTION FROM  
REGULATED THIRD PARTY ACCESS FOR ISLE OF GRAIN PHASE 4 – OFGEM'S FINAL  
DECISION**

This letter sets out Ofgem's final view on National Grid Grain LNG Ltd's ('GLNG') application for an exemption. GLNG is planning a fourth phase of development, to expand its Isle of Grain LNG terminal by 8.4 billion cubic meters per year (bcm/y) of import capacity ('Phase 4'). Phase 4 would increase importation capacity at the facility from the existing 20 bcm/y to 28.4 bcm/y.

GLNG has applied for an exemption from regulated third party access ('rTPA') requirements for this expansion. GLNG is currently finalising an open season process to sell capacity for Phase 4; firms bids were received in November 2011 and negotiations are currently being held with three parties. GLNG has submitted to us confidential information regarding, amongst other things, the identity of these three bidders.

On 12 November 2012, Ofgem published a consultation document<sup>1</sup> on the exemption application from rTPA requirements submitted by GLNG in relation to phase 4. In the consultation document we set out our initial view that, based on our analysis of GLNG's application against the exemption criteria set out in the legislation<sup>2</sup> ('the criteria'), an exemption from rTPA requirements for Phase 4 should be granted subject to a number of conditions.

We received six responses to the consultation including one from the applicant. Four of these responses were non-confidential and were published on Ofgem's website soon after the consultation closed<sup>3</sup>.

Two respondents expressed clear support for Ofgem's decision to grant an exemption and no one opposed the decision. After giving due consideration to the responses received to the November consultation document we consider that an exemption should be granted for Phase 4. Ofgem continues to believe that all the criteria are met by Phase 4 for the reasons set out in our November consultation document. Attached to this letter is the final exemption order granted by the Gas and Electricity Authority (the 'Authority').

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<sup>1</sup> National Grid Grain LNG's application for exemption from regulated third party access for Isle of Grain phase 4 - our initial views and questions for consultation:

<http://www.ofgem.gov.uk/Markets/WhIMkts/CompandEff/TPAccess/Documents1/Isle%20of%20Grain%20-phase%204%20consultation%20letter.pdf>

<sup>2</sup> These criteria are set out in Section 19C (7) and Section 19DB of the Gas Act 1986 (as amended).

<sup>3</sup><http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=180&refer=Markets/WhIMkts/CompandEff/TPAccess>

Although our view is fundamentally unchanged, in light of consultation responses we have made a number of adjustments and clarifications to the conditions we consulted on; this will improve on the draft exemption by providing additional certainty, flexibility and ensure our original policy intent is achieved without creating unintended consequences.

Attached to this letter is:

- The adjustments and clarifications we have made to our initial view set out in the November consultation document along with our reasoning for these changes. An annex to this section sets out in more detail our view of the competition criteria and how this relates to our view regarding capacity allocation; and
- The final exemption order.

In summary our view is that the exemption should be granted and that the exempt Phase 4 capacity be split into three separate tranches (reflecting the bids for primary capacity from three separate market participants) and is exempted for the following durations:

- Tranche A: 3.7 bcm/y for 22 years;
- Tranche B: 2.6 bcm/y for 20 years; and
- Tranche C: 2.0 bcm/y for 13 years.

When the exempt period for each tranche of capacity ends the capacity will fall within the rTPA regime; we note that using this approach capacity is exempt on average for roughly 19 years<sup>4</sup>. Anti-hoarding arrangements for selling any unused capacity would be subject to periodic reviews.

### **Way forward**

We will notify the European Commission of our decision. The Commission will then have two months from the day following receipt of our decision, to request us to withdraw or amend it<sup>5</sup>.

If you have any questions or comments on the content of this letter, please contact Andrew Pester at [Andrew.Pester@ofgem.gov.uk](mailto:Andrew.Pester@ofgem.gov.uk)

Yours faithfully,

Pamela Taylor  
Associate Partner, Gas and EU Coordination

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<sup>4</sup> This is used taking the weighted average of the capacity and the period for which it is exempt.

<sup>5</sup> See Article 36(9) of the European Gas Directive of 13 July 2009.

## ADJUSTMENTS AND CLARIFICATIONS TO EXEMPTION CONDITIONS

As noted above, our view is fundamentally unchanged from our initial decision. Our view is that all the exemption criteria have been met and therefore that an exemption should be granted. However, after considering responses to our consultation we have decided to make adjustments and clarifications to some of the conditions we will apply. These are discussed below.

### *Scope of the exemption*

In our November consultation document, we proposed that the exempted capacity should be tied to the initial contracts with primary capacity holders as set out in GLNG's application and that capacity should fall within the rTPA regime once the initial contracts expired. In order to truncate the duration of one part of the exempt capacity we capped the length of the exemption to a 24 year period<sup>6</sup> rather than the 27 year duration sought by GLNG; in doing so we were mindful of guidance<sup>7</sup> produced by the European Commission that states that capacity should be exempted, at a maximum, to the pay-back period for the investment. Although GLNG has sought a longer exemption, our view is that the duration of the exemption set out in our initial decision remains appropriate.

In GLNG's response to our consultation it sought clarity on what would happen in the event of default on a contract.

In our view, the capacity exempted in this decision should be given the same regulatory certainty (i.e. that the capacity should remain exempt even in the event of a default of a counterparty) as other exempted facilities. Therefore, to make our intention clearer and less prone to unintended consequences we have decided to redraft this condition by splitting Phase 4 into three separate tranches (reflecting the bids for primary capacity from three separate market participants) with each exempted for different periods. The exempted durations are as follows:

- Tranche A: 3.7 bcm/y for 22 years;
- Tranche B: 2.6 bcm/y for 20 years; and
- Tranche C: 2.0 bcm/y for 13 years.

When capacity comes to the end of its exempt period then this capacity would be subject to the rTPA regime. We note that under this approach capacity is exempt on average for roughly 19 years<sup>8</sup> though has the advantage of ensuing some capacity enters the rTPA regime at a relatively early stage (after 13 years) compared to a scenario where all the capacity were granted as a block exemption.

### *Process for reallocation of capacity in the event of a default*

In GLNG's response to our consultation its view was that they should be able to reallocate exempt capacity quickly in the event of default by a primary capacity holder without having to agree terms with Ofgem. In our view, reallocation to a different market participant would raise questions about whether the criteria were still met (especially the competition criterion) and about the process by which the capacity should be reallocated.

We set out later in this document the range of capacity allocations that we deem to meet

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<sup>6</sup> The 24 year period in our initial decision would have started when the first tranche of capacity became operational. In GLNG's application tranche A starts 2 years later than the other tranches of capacity meaning it would be exempt for 22 years only.

<sup>7</sup> See paragraph 17 in 'Commission Staff Working paper (6 May 2009) on Article 22 of Directive 2003/55/EC concerning common rules for the internal market in natural gas and Article 17 of Regulation (EC) No 1228/2003 on conditions for access to the network for cross-border exchanges in electricity- New Infrastructure Exemptions'. [http://ec.europa.eu/energy/infrastructure/infrastructure/gas/doc/sec\\_2009-642.pdf](http://ec.europa.eu/energy/infrastructure/infrastructure/gas/doc/sec_2009-642.pdf)

<sup>8</sup> This is used taking the weighted average of the capacity and the period for which it is exempt.

the competition criterion. In our view, the existing competition analysis provided by GLNG and our conditions regarding capacity allocation could be informative if any default were to occur in the near future (say, within the next five years and if market conditions had not changed significantly). We can clarify that under these conditions we may not need a new competition assessment to be undertaken and instead we could rely on the extant competition assessment.

In terms of the process for allocating the capacity we recognise the advantage both to GLNG and the market as a whole for primary capacity to be made available as soon as possible after a default by reallocating it quickly. We have clarified above that this capacity would remain exempt, however in these circumstances we still expect GLNG to agree the process of reallocation with us.

#### *Flexibility around the timing of each tranche*

In GLNG's response to our consultation its view was that additional flexibility should be granted so that construction and operation of each tranche could be tailored to the timing of the underlying contracts (which might change compared to the timings set out in their application).

We agree that this facility should have the same flexibility regarding construction and operation as other exempt facilities. However, provisions contained in Section 19CA(3) of the Gas Act 1986 and Article 36 of the Gas Directive 2009/73/EC make clear that construction must have started within two years from the date of the exemption decision and it has to be operational within five. We think that subject to these limits this gives GLNG a degree of flexibility about when construction could start and when each tranche could become operational. To be clear, we consider that unless all three tranches of the capacity are operational within five years we would consider these provisions will have been breached.

#### *Interaction of exempt and rTPA capacity*

In its response to the consultation GLNG view was that capacity that would be subject to rTPA might interfere with the rights of capacity that would still be exempt during the period when exempt and rTPA capacity coexist.

We can clarify that it is not Ofgem's intention to undermine the value of exempt capacity; in designing the rTPA regime for Phase 4 we will take into account the rights of those holding exempted capacity, who will be sharing it with rTPA customers. We also consider that it is for GLNG to make sure that rTPA and exempt capacity can coexist so that the operation of phase 4 is not compromised and the value of exempt capacity not negatively affected.

#### *Capacity allocation*

In our November consultation document, we noted the status of the open season process for the allocation of Phase 4 and summarised the analysis undertaken by Frontier Economics. Based on GLNG's application and Frontier's analysis we set out our view that the competition exemption criterion was met, specifically if the outcome of the open season process was consistent with the information contained in GLNG's application (in terms of number of bidders, their capacity shares and duration of the underlying contracts with GLNG), and the arrangements for making unused capacity available to third parties were subject to regulatory approval and periodic reviews by us.

GLNG thought Ofgem might needlessly reopen the exemption decision should the eventual results of the open season differ from that set out in its original exemption application. In its view, Frontier Economics' competition assessment suggested that Ofgem need not to reopen the exemption decision regardless of the outcome of the open season.

In Ofgem's view, exemption decisions should be made based on the application submitted

by the developer and that there should be sufficient nexus between the facts presented in the application and the developer's actual project. Should significant differences arise between a developer's application and what the developer wishes to do in practice we must be informed of this to allow us to consider whether the change is material with regards to the grounds for the exemption decision.

We recognise that it could increase regulatory certainty and reduce unnecessary administrative costs to all parties (including Ofgem) if we were to provide guidance on an additional scenario that we would deem would still meet the competition criterion. This could help avoid having to needlessly reopen the exemption decision.

In conclusion we can clarify that were a single market participant to acquire two of the three tranches of Phase 4 (regardless of which market participant ended up with the capacity) and if arrangements for making unused capacity available to third parties are subject to periodic reviews and approval the competition exemption criterion would be deemed to be met. If the open season results in an allocation of capacity that is not consistent with this rule then GLNG must inform us. We have set out our full reasoning in an annex to this attachment.

### *Anti-hoarding arrangements*

In our November consultation document we considered that more transparent and streamlined anti-hoarding arrangements may be required in the future as LNG becomes a more important source of gas supply for the UK<sup>9</sup>. Given the increasing importance of LNG in meeting UK's gas demand in the future, we were therefore minded to grant the exemption subject to regulatory approval of anti-hoarding arrangements for phase 4 and their subsequent periodic review.

Those who responded opposed our proposals did so on the grounds that current arrangements were currently satisfactory and were expected to remain so, that changes should be supported by LNG participants in general and that any rules should be applied consistently across LNG facilities as well as other sources of gas supply.

We agree that given current market circumstances there is no urgent need to review the anti-hoarding arrangements at LNG facilities - we have consulted on this issue recently in our rTPA guidance document<sup>10</sup> and no market participants raised concerns about current practices in the GB market. However, we are unconvinced that this situation will remain - as GB (and the European market more generally) becomes increasingly reliant on LNG we may wish to review anti-hoarding arrangements at LNG facilities.

We have decided to maintain the condition that anti-hoarding should be subject to periodic review by us. However, we have decided to adjust our condition to allow more flexibility regarding the timing with which we hold these reviews; our intention is to only hold reviews when factors, such as market conditions, suggest such a review would be timely. This may or may not occur before phase 4 starts its commercial operation. It should be noted that we expect to apply the condition of periodic reviews to all future LNG exemptions regardless of the applicant. Furthermore, to ensure that distortionary effects are avoided, we can clarify that any review would encompass anti-hoarding arrangements at other LNG import terminals in GB. We do not intend that primary capacity holders at phase 4 should face anti-hoarding terms that are unduly onerous compared to others in the market.

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<sup>9</sup> For example, National Grid in its Ten Year Statement (2011) forecasts that due to the decline in UK gas production, LNG would become the major long-term supply source to the UK and that more LNG import infrastructure might be needed.

<sup>10</sup> See page 16:

<http://www.ofgem.gov.uk/Markets/WhlMkts/CompanEff/Documents1/Guidance%20on%20the%20regulated%20Third%20Party%20Access%20regime%20for%20Liquefied%20Natural%20Gas%20Facilities%20in%20GB.pdf>

## **ANNEX: OFGEM'S GUIDANCE REGARDING THE COMPETITION CRITERION**

As noted above we believe there should be sufficient nexus between the facts provided in the application and the developer's project. However, we recognise that given the status of the open season there would be an advantage to all parties (including Ofgem) by providing guidance on another scenario that we would deem would still meet the competition criterion; this could avoid the exemption decision being reopened needlessly. We discuss below our competition assessment and then explain how we come to the view that were a single market participant to acquire two of the three tranches of Phase 4 we would deem that the competition criterion would still be met.

### *Competition Assessment*

The issue that we are seeking to consider is what impact the exemption will have on competition on the relevant markets. In terms of the product market, we consider it appropriate to examine both the wholesale market and the flexibility market as the directly affected markets. In terms of the geographic market, we consider it appropriate to examine the GB market but also look more widely at the potential impact on wider market definitions too i.e. North West Europe and European wholesale gas markets given these are the primary markets in which the additional source of LNG capacity is offered for sale; in informing our decision we believe it's appropriate to give each of these market definitions weight.

It may be that if LNG demand increases in GB and the LNG regasification market increases, it is possible for one player to acquire an increasing share of a growing market and reduce the incentives for others that might otherwise have entered to enter. Ofgem is mindful of potential dynamic effects such as these. In light of this, we consider that measures of market concentration (such as market shares, number of firms and the Herfindahl-Hirschman Index) can be informative as they help indicate whether one of more market participants may be able to acquire market power.

As reported in our consultation document, we note that Frontier Economics' analysis shows that increases to HHI in the 'worst case' scenarios (ie UK flexibility markets, North West Europe wholesale gas and Europe wholesale gas markets) were generally relatively small (below 250) and HHI levels generally remain relatively low (generally below 1,000). We also note that under the vast majority of 'worst case' scenarios (spanning both the wholesale and flexibility market) the market share of the largest player remains relatively low.

Ofgem's view is that using 'Pivotality Analysis' is also an important tool in assessing market power in the gas wholesale market. Pivotality Analysis identifies the market players that are 'pivotal' by using demand and supply data. When a market player is pivotal, total demand cannot be met from the total supply from all other sources of supply. Therefore, the market player will not face material competitive constraints for its pivotal volume of supply, and is therefore guaranteed a certain market share as a result of the lack of competing supply. The degree of a market player's market power may be assessed by looking at its pivotal volumes of supply (as a percentage of total demand) over a range of timeframes.

We note that the corollary of Pivotality Analysis is that any investment in new capacity would tend to enhance the degree of competition in the relevant market so long as the capacity is allocated to two or more players. The reason for this is that the additional capacity reduces the ability of other capacity in the market to compete and by allocating the new capacity to two or more market players the investment reduces the ability of any individual market participant to influence market prices by withdrawing its capacity from the market.

We also note that even were market power to be acquired, there are important mechanisms to prevent its abuse:

- The possibility of further entry into the LNG re-gasification market. We note that there has been significant investment in this market in recent years and that there are a range of developers seeking to enter the market at present;
- The anti-hoarding arrangements required for all LNG regasification terminals. We consider the effectiveness of these as important;
- The Rough Undertakings (which were recently reviewed by the Competition Commission) which are important at ensuring the 'flexibility market' remains competitive<sup>11</sup>. The Frontier Economics report ignored the impact of these remedies and so may overstate competition concerns in the flexibility market; and
- The wider regulatory and competition legislation which helps provide protection against any future abuse within the GB gas market. For example, Ofgem has concurrent powers with the Office of Fair Trading (OFT) to investigate and fine companies under the Competition Act 1998 for anti-competitive conduct.

*How the criterion is met if a single market participant acquires two of the three tranches*

We consider that were a single market participant to acquire two of the three tranches of Phase 4 the competition criterion would still be met, regardless of which market participant ended up with the capacity. This is because:

- the corollary of Pivotality Analysis (discussed above) would suggest that this would lead to an enhancement of competition since more than one player would be acquiring capacity; and
- this would help to ensure that market concentration should not materially increase and remain below the levels set out in the Frontier Economics report regardless of which market participant were to get the majority of the capacity.

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<sup>11</sup> The Rough Undertakings related to the largest storage facility in GB whilst is owned by a subsidiary of Centrica. These undertakes put in place a number of remedies such as effective separation, rules around capacity allocation, and limits on the share of capacity that Centrica can acquire. Further information can be found here. <http://www.competition-commission.org.uk/our-work/reviews-of-orders-and-undertakings/completed-reviews/review-of-centrica-undertakings>

**GAS ACT 1986  
SECTION 19C  
EXEMPTION**

Pursuant to sub-section 19C (5) of the Gas Act 1986 (the Act), the Gas and Electricity Markets Authority hereby gives to Grain LNG Ltd (Phase 4)<sup>12</sup>, as owner of an LNG import and export facility, an exemption from the application of section 19D of the Act in respect to the LNG import and export facility located at the Isle of Grain, Nr Rochester, Kent, ME3 0AB subject the attached Schedule.

Pamela Taylor  
Authorised in that behalf by the Gas and Electricity Markets Authority  
Dated [        ]

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<sup>12</sup> Registered in England No 446379. Registered Office 1-3 Strand, London, WC2N 5EHX.



**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
"the Act"	means the Gas Act 1986 as amended from time to time
"the facility"	means LNG import and export facility
"facility owner"	means Grain LNG Ltd in its capacity as owner of the facility
"facility operator"	means Grain LNG Ltd in its capacity as operator of the facility
"throughputter"	means any user of the facility

**B. Full description of the LNG import or export facility to which this exemption relates**

The exemption relates only to the following volumes:

Tranche A: comprising 3.7 bcm/y;  
Tranche B: comprising 2.6 bcm/y; and  
Tranche C: comprising 2.0 bcm/y.

**C. Period**

Subject to Section E below, and pursuant to section 19C(3)(a), this exemption will cease to have effect in respect of the capacity at:

Tranche A for 22 years;  
Tranche B for 20 years; and  
Tranche C for 13 years.

**D. Conditions**

Pursuant to sub-section 19C (3)(b) and (c) 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 the exemption is and remains accurate in all substantial respects.
2. In the event that the result of the Open Season is different from that submitted in the application in respect of the exemption, the facility owner shall notify the Authority as soon as possible. The facility owner will allocate the exempted capacity in the manner described in the Decision letter.
3. The facility owner notifies the Authority within ten days of the capacity of the facility commencing commercial operation.
4. The facility owner has effective anti-hoarding measures in place approved by the Authority. Such measures shall be subject to periodic review and approval by the Authority.
5. 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 may be necessary, for the purpose of:
  - (a) performing the function assigned to it by or under the Act, the Utilities Act 2000, or the Energy Act 2004; or
  - (b) monitoring the operation of the exemption.

6. 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 specified or described.
7. 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 pipeline 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

8. Should any of the grounds for revocation arise under section E of this exemption, the Authority may amend this exemption rather than revoke the exemption.
9. The Authority may amend this exemption where the Authority has been requested to amend the decision to grant this exemption by the European Commission (such request being made in accordance with Article 36(9) of Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009).
10. This exemption is transferable to another facility owner where the Authority has reviewed the conditions of the exemption and given its written consent to such a transfer subject to any conditions which the Authority considers appropriate.

## **E. Revocation**

Pursuant to sub-section 19 CA (5) of the Act, this exemption may be revoked in the following circumstances:

The Authority may revoke this exemption where the European Commission has requested (in accordance with Article 36(9) of Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009) that the Authority withdraw the decision to grant this exemption.

The Authority may revoke this exemption where the European Commission has requested (in accordance with Article 36(9) of Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009) the Authority to amend the decision to grant this exemption and the facility owner does not agree (under paragraph D7 above) for this exemption to be amended in the manner so requested by the European Commission.

The Authority must revoke this exemption if the construction of the facility has not been started within 2 years from the date of this exemption or if operations at Grain LNG (Phase IV) do not commence operations within 5 years from the date of this exemption decision in accordance with section 19 CA(3) of the Act.

This exemption may also 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 any or all of the conditions contained in section D are no longer met;
- ii. in the Authority's reasonable opinion there is a material change in the degree to which the requirements of sub-section 19C (7)(a), (c), (d) or (e) of the Act are met with respect to the facility as the result of any action or omission of the facility owner, facility operator or throughputter;
- iii. the facility owner has a receiver (which expression shall include an administrative receiver within the meaning of section 251 of the Insolvency Act 1986) of the whole or any material part of its assets or undertaking appointed;
- iv. the facility owner has an administration order under section 8 and Schedule B1 of the Insolvency Act 1986 made in relation to it;
- v. the facility owner is found to be in breach of the Competition Act 1998; or
- vi. there is merger or acquisition activity in relation to, or by the facility owner, that is detrimental to competition.

(b) the facility owner has failed to comply with a request for information issued by the Authority under paragraph D (5) 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 D (6) 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.