



**EUROPEAN COMMISSION**  
DIRECTORATE-GENERAL FOR ENERGY AND TRANSPORT

Director-General

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Sir John Mogg  
Office of Gas and Electricity Markets  
9, Millbank  
London SW1P 3GE  
United Kingdom

**SUBJECT: EXEMPTION DECISION NO. G/2005/001, DRAGON LNG TERMINAL**

Dear Sir John,

I am writing with reference to your exemption decision from certain parts of the Gas Directive 2003/55 for the above mentioned project, notified to the Commission on 3 February 2005.

The relevant Commission services have analysed the decision and supporting material and agree that the exemption decision is in line with the conditions set out in the Directive. Therefore I hereby inform you the Commission has not decided to request OFGEM to amend or withdraw its decision.

The Commission services have some observations regarding the competition analysis provided by Ofgem, which are attached.

Yours sincerely,

François Lamoureux

*(signé)*

## ANNEX

### **OBSERVATIONS OF THE COMMISSION SERVICES ON THE COMPETITION ANALYSIS PROVIDED BY OFGEM RELATING TO THE EXEMPTION ORDER GRANTED TO THE “DRAGON” LNG TERMINAL**

The competition analysis provided by Ofgem has been used by the Commission to assess that the conditions (a) and (e), relating to the competitive impact of the project and the subsequent exemption from third party access, are fulfilled. In particular, the investment “must enhance competition in gas supply” and the act of granting the exemption should not be “detrimental to competition or the effective functioning of the internal gas market”.

In this context the key feature of the project is the presence of Centrica, the largest UK gas supplier by market share, as the counterparty to a long term purchase contract with Petronas, one of the throughputters participating in the terminal. The contract between Petronas and Centrica will cover all of the gas imported through the terminal, that is to say 50% of the total capacity of the first phase, 3 bcm/year, for a period of 15 years.

As a result of successful market opening in the UK it is true that Centrica can no longer be seen as “the incumbent” in the sense in which the positions of some companies from continental markets would be interpreted. However it continues have a strong position in the retail gas market in the UK with an overall share of around 35% of the market, including 59% of the household market, a consequence of its former position as the monopoly supplier.

In its competition analysis, Ofgem submit that the UK market is sufficiently competitive and liquid such that competition in the retail market would not, under any circumstances, be affected by contractual arrangements in the gas wholesale market. Therefore it is considered that the involvement of Centrica through their contract with Petronas, and with this capacity secured through the exemption, could not be detrimental to competition in the retail market in the UK. This analysis is based on three conditions concerning equal access by potential market actors to (1) gas itself, (2) transportation capacity and (3) flexibility services. Ofgem consider all these conditions are fulfilled in the UK.

The services of the Commission have no observations regarding Ofgem’s analysis relating to conditions (2) and (3) above since access to transportation capacity as well as the bulk of flexibility services (i.e. access to the largest storage facilities) are regulated. However, the services of the Commission would like to make the following comments on Ofgem’s analysis of the point (1).

A pivotal point, on which Ofgem's analysis of this issue appears to be based, is the **permanent excess of supply over demand**. This has certainly been the case until recently, in view of the UK position as a net exporter of gas. On the other hand, no one doubts that this situation is about to change and indeed Ofgem do not disregard this change as such. However it presents, in the view of the Commission services, an optimistic view that all the currently known projects are to be developed, which would mean approx. 100 bcm of new import capacity installed in the UK before 2010. As a result, the “oversupply” conditions are foreseen to last at least in the medium term.

Ofgem admits that there is a significant degree of uncertainty associated with such projections. However this uncertainty is not carried forward into its conclusions that long-term arrangements on the wholesale would never feed through onto the retail market.

For example, if progress on projects to import gas did not materialise, a scenario could emerge whereby excess demand may lead to upward pressure on wholesale prices. In this circumstance, those companies with a strong position in both the wholesale market as a result of their contract position, and in the retail market, may seek to use this situation to block competitors while also maintaining or increasing their overall profit margins.

It would seek to do this by interfering with the intra-market price signalling mechanism by trying to prevent the transmission of price signals from the retail to wholesale level. For example, in a situation of excess demand, it may be profitable for a company, dominant on the retail market, to attempt to drive up retail prices while ensuring that the wholesale price is kept as low as possible to give a disincentive to new investments (which are themselves only realised with a substantial lag). Although competitors may seek to undercut the dominant player in the retail market, the incumbent would seek to prevent this by a credible threat to respond by manipulating prices upwards in the wholesale market by withdrawing some of its contracted gas and also responding quickly with price reductions in the retail market. Such a threat is credible because by entering into a long term gas purchase contract, and committing itself to buy a certain quantity of gas, the incumbent gives a signal to competitors that it would retaliate to attempts by competitors to take away its market share.

For the UK market, it is agreed that, in general, this risk is rather limited in view of the fact that Centrica is not projected to have a dominant position in the wholesale market and that there is likely to be a variety of players with a similar positions in terms of the mixture of long, medium and short term contracts. This will reduce the credibility of any threat on the part of Centrica or any other company to interfere either with the wholesale or retail price of gas. In addition, the risk of price manipulation stemming directly from the project is, to some extent, reduced because Centrica will be *de facto* obliged to take gas from the terminal on a flat profile. However in periods of particular tightness between supply and demand and increasing prices such as autumn-winter 2004, it may be that certain companies would have a pivotal effect on price formation as a result of their contractual position and also could rely on retaining at least a proportion of their final customers even where they are increasing prices. Whether this latter effect is due to customer inertia, or the result of a credible threat of a response by the incumbent is immaterial to the result which would be a deterioration in competitive conditions and a net loss to the customers affected.<sup>1</sup>

Against this background, it seems indispensable to ensure that remedial measures are possible in the event of such a scenario becoming a persistent feature of the UK market. In this context the Commission services note the stated intention of Ofgem to continue to review the UK market and to act, in the first instance, through its Competition law competences, to prevent potential abuses of the type mentioned. We also understand that, apart from the general monitoring of the market, Ofgem still intends to undertake a “special purpose” review of the state of the retail market, to which the Commission services referred to in their informal guidance relating to another exemption request. Together with the

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<sup>1</sup> Centrica currently holds approx. 60% of the gas market for households. Ofgem’s paper is right to point that for the time being Centrica is losing its market share. However, this should be analysed in the context of the heavy price increases which the UK households have recently witnessed. According to Ofgem’s paper, Centrica retains higher mark-ups than other gas suppliers. One may argue that such behaviour proves high market power and that Centrica seems to be a textbook example of a company with inelastic demand curve whereby, price increases lead to higher earnings because customer losses are outweighed by growing margins per customer.

indications that the share of gas in the wholesale market covered by current contracts to Centrica is likely to fall significantly in the period of the exemption from some 45% to less than 20%, this commitment by the regulator would appear to be sufficient to ensure the continued fulfilment of the conditions (a) and (e) of the Directive relating to the Dragon project in spite of the indirect involvement of a company with already a moderately strong position in the retail market.

Finally, to avoid any doubt, it should be underlined that the present observations are without prejudice to the Commission services' discretion to comment on any future analysis presented by Ofgem or by any other national authority in the context of the Article 22 procedure. We would like to raise your attention to the fact that a separate competition analysis, which the Commission will assess on its own merits, shall be submitted in each individual case covering all the national markets affected. It also means that Ofgem's comments (see footnote 2 of the paper on Dragon) relating to the BBL project, which has not yet been formally notified, cannot be considered valid as it is not based on the merits of that case.