EUROPEAN
COMMISSION

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COMMISSION DECISION

of 4.6.2013

on the exemption of LNG Terminal on Isle of Grain, the United Kingdom, from the internal market rules on third party access and tariffs provisions according to Article 36 of Directive 2009/73/EC

(Text with EEA relevance)

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(Text with EEA relevance)

THE EUROPEAN COMMISSION,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to Directive 2009/73/EC[1], and in particular Article 36 thereof,

Whereas:

1. Procedure

(1) On 8 March 2013, the Office of Gas and Electricity Markets of the United Kingdom (hereinafter, "notifying authority" or "OFGEM") adopted a Decision ("the Exemption Decision") granting National Grid Grain LNG Ltd (hereinafter also "the Applicant"), a company wholly owned by National Grid plc, a temporary exemption from the obligation to provide regulated third party access (including tariffs) to a planned fourth phase expansion of the Liquefied Natural Gas Regasification Terminal (hereinafter, "LNG Terminal") facility on the Isle of Grain (hereinafter, "Grain LNG Phase 4") in accordance with Section 19 C(7) and Section 19 DB of the UK Gas Act, as amended, for 100% of the capacity subject to a number of conditions.

(2) The notifying authority issued a consultation document on 12 November 2012 and the Exemption Decision on Grain LNG Ltd.'s request for exemption on 8 March 2013.

(3) The Exemption Decision was adopted in line with the national legislation implementing Directive 2009/73/EC, which is the Gas Act of 1986 as amended with the Electricity and Gas (Internal Markets) Regulations 2011 (SI 2011 No. 2704). In particular, section 19D of the Gas Act requires the owner of an LNG facility to allow open and non-discriminatory access to their facility. Section 19C(7) and Section 19DB of the Gas Act 1986 (as amended) set out the criteria that must be met for granting an exemption from Third Party Access Provisions.

(4) The Exemption Decision was notified to the European Commission by letter dated 3 April 2013 and received by the registry of the European Commission on the same day.

(5) On 10 April 2013, the Commission published a note informing the public of the notification and inviting third parties to send any observations they may have on this subject until 24 April 2013. No such observations were received.

2. Description of the project

(6) The planned Grain LNG Phase 4 will expand the total yearly import capacity of the Grain LNG Terminal located on the Isle of Grain by up to 8.4 bcm, which will result

[1] OJ L 211 of 14.8.2009, p.94.

in an increase of Grain's facility total importation capacity from the existing 20 bcm/year to approximately 28.4 bcm/year. The cost of the expansion will be approximately GBP [BUSINESS SECRET] and the expansion will consist of:

– 190 000 m³ of total containment tank,

– a second unloading line and

– additional regasification and associated process equipment.

(7) Grain LNG Phase 4 will be connected to the UK's national transmission system operated by National Grid Gas plc through reinforcement works carried out by Grain LNG Ltd under a preconstruction agreement with National Grid Gas.

(8) Construction works of Grain LNG Phase 4 are planned to start in the end of 2013 and commercial operations are envisaged to commence by winter 2016/17.

(9) Grain LNG Phase 4 will be owned and operated by Grain LNG Ltd a wholly-owned subsidiary of National Grid plc.

(10) Grain LNG Ltd wishes to reserve the primary capacity of Grain LNG Phase 4 to the three parties currently involved in the Open Season process (hereinafter also "the primary capacity holders") under long term agreements (between 13-25 years) with pre-agreed revenue streams. According to the Applicant, in the absence of the exemption from regulated Third Party Access rules for the entire extended capacity, Grain LNG Phase 4 project would not be economically viable.

3. The notified decision

(11) The Exemption Decision grants the Applicant an exemption from Third Party Access and tariffs provisions under the following conditions:

- that the exempt Grain LNG Phase 4 capacity is split into three separate tranches comprising the following volumes:
  – Tranche A: 3.7 bcm/y;
  – Tranche B: 2.6 bcm/y; and
  – Tranche C: 2.0 bcm/y.
- that each Tranche of capacity is exempted for the following durations:
  – Tranche A: 22 years (from 2018);
  – Tranche B: 20 years (from 2016); and
  – Tranche C: 13 years (from 2016).
- that when the exempt period for each Tranche of capacity ends that capacity ("uncontracted capacity") will be subject to regulated Third Party Access rules; and
- that anti-hoarding arrangements for selling any Grain LNG Phase 4 unused capacity are subject to the approval and periodic reviews by the notifying authority.

(12) In the view of the notifying authority, the duration of the exemption cannot exceed 24 years, i.e. from 2016, when the first element of Phase 4 capacity commences commercial operations, until 2040. The notifying authority reserves the right to reconsider the exemption decision should the final result of the Open Season be materially different from that submitted by the Applicant in respect of the exemption.

(13) According to the UK legislation the so-called sunset clause applies, according to which the exemption shall become null and void if work on the site does not commence within two years from the date of the exemption decision and if the regasification terminal is not operational within five years from the date of the exemption decision. The notifying authority considers that all three tranches of the capacity must be operational within five years.

4. The UK gas sector

(14) Until 2004, the UK was a self-sufficient producer of gas; however since 2002 the gas production from the UK Continental Shelf (UKCS) began to decline, whilst UK gas consumption continued to increase. The UK is now a net importer of gas. UK net imports of gas account for over 40% of UK primary energy demand. Gas can be imported to the UK through two pipelines connecting it to the continental European systems (Interconnector UK and the Balgzand-Bacton Line), pipelines connecting the UK to Norwegian offshore production and through LNG import terminals at South Hook LNG and Dragon LNG at Milford Haven as well as Grain LNG. Currently the bulk of LNG imports to the UK, including imports to Grain LNG, are sourced from Qatar.

(15) The UK wholesale market is based on trading between gas producers, shippers, suppliers, traders and customers across a series of markets. Natural gas producers or third parties with access to bulk gas can easily participate in the wholesale market, and the wholesale level is the same as the upstream sale (since the delivery point is NBP). Therefore, it can be said that in the UK there is one single wholesale market instead of an upstream and a downstream wholesale market like in certain other EU Member States. According to available data, there is no single dominant player at the wholesale level. OFGEM has indeed indicated that the UK wholesale market has low levels of concentration and that no parties are able to exert significant market power.

(16) In view of the specificities of the UK gas markets, including the liquid and competitive wholesale level, there is no need for an additional analysis of the retail level (retailers having ample opportunity to source gas competitively on the wholesale market).

5. Assessment of the conditions for an exemption

(17) The planned Grain LNG Phase 4 qualifies as a major new gas facility within the meaning of Article 36(1) read in conjunction with Article 36(2) of Directive 2009/73/EC as the additional 8.4 bcm of import capacity represents a significant increase of yearly regasification capacity in existing infrastructure which enables the development of new sources of gas supply to the UK.

(18) The investment is substantial [BUSINESS SECRET], within the average amount invested in previous expansions of the terminal ([BUSINESS SECRET]m for Phase 2 and[BUSINESS SECRET]m for Phase3). In addition, Phase 4 has the potential to bring substantial new capacity as it will represent slightly less than 1/3 of the entire terminal’s capacity (i.e. 8.4 bcm/year out of 28.4 bcm/year).

5.1 Conditions for an Exemption according to Article 36

5.1.1 The investment must enhance competition in gas supply and enhance security of gas supply; Article 36 (1) (a) of Directive 2009/73/EC

(a) Enhancement of competition

(19) According to Article 36 (1) (a) of Directive 2009/73/EC the investment must enhance competition in gas supply. For the analysis of this condition, the likely positive and negative effects of the investment on competition need to be analysed and balanced. Only if the positive effects of the investment outweigh the negative effects, an exemption under Article 36 can be granted.

(20) The Applicant has run two Open Seasons to identify market demand for the additional LNG import capacity at Grain LNG Phase 4. In total 3 companies have expressed their interest to book capacity on Grain LNG Phase 4 terminal for the overall demand of 8.4 bcm/y.

(21) Based on the information provided by the notifying authority, one of the new primary capacity holders is likely to be [BUSINESS SECRET] as the construction of additional capacity at Grain LNG Phase 4 can facilitate the import of LNG from [BUSINESS SECRET]. [BUSINESS SECRET] currently does not have a significant presence on the UK market and [BUSINESS SECRET] development project has not been completed yet. In addition, [BUSINESS SECRET] has expressed its interest to book capacity at Grain LNG Phase 4. Neither [BUSINESS SECRET] are currently holders of primary capacity at Grain LNG.[BUSINESS SECRET] is present at the UK gas market, mainly at retail level. Finally, [BUSINESS SECRET], , has confirmed its interest in acquiring capacity after concluding a contract with an upstream supplier. [BUSINESS SECRET] is active on the UK market, both at the wholesale level and at the retail level.

(22) The Commission considers that the construction of the additional capacity at Grain LNG Phase 4 has the potential to increase the supply sources to the UK and increase the number of primary LNG capacity holders from 11 to 13. This has the potential to enhance competition in the UK wholesale gas market. In addition, considered from a North West European view point (i.e. including the UK, the Netherlands, Belgium, Germany and France), the Grain LNG Phase 4 import capacity also has the potential to increase both supply route competition and hub- to -hub competition. Moreover, insofar as the new capacity will be allocated to two (or more) potential new entrants, the ability of any individual market participant to influence market prices by withdrawing its capacity from the market is reduced.

(23) However, it is important to avoid a situation where the whole capacity of all the three tranches is allocated to one and the same market operator. In fact, whilst two of the prospective customers currently do not have a significant presence on the UK wholesale gas market, the long duration of the exemption is expected to guarantee to these new entrants/small players in that market a privileged access to the downstream market for a long period of time (which would essentially correspond to the duration of each proposed upstream long term agreements). Such long term perspective would make it more difficult to foresee what the market power of these prospective customers will be in 20 years' time or more.

(24) A similar consideration would also hold with regard to the third prospective customer, [BUSINESS SECRET], despite the expected shorter duration (13 years) of the upstream supply deals and the current relatively low market share [BUSINESS SECRET] of this operator on the wholesale market as well as OFGEM's reassurances about the existence of mechanisms that would prevent any potential abusive behaviour by this company.

(25) Whilst the Commission considers that the positive effects on competition expected from the investment would be reduced if only one user reserved all of the long-term

regasification capacity for itself, the Commission can agree with the notifying authority that the investment is likely to enhance competition in those cases where at least two market participants acquire capacity and no one user acquired more than two of the three Tranches. As such there would be an increase in the number of primary LNG capacity holders in the UK, which indicates that there would be an enhancement of competition from the construction of this infrastructure. This would also effectively restrict the amount of capacity that would be available to any individual party.

(26) The Commission accepts that there is a positive impact on competition based on the capacity being allocated in accordance with outcomes from the Open Season process.

(27) On this basis, the Commission considers that the requirements of Article 36(1)(a) Gas Directive relating to enhancement of competition due to the investment are met.

(b) Enhancement of Security of Supply

(28) The notifying authority submits that Grain LNG Phase 4 enhances security of supply as it increases LNG import capacity by approximately 8.4 bcm/y and contributes to the diversification of sources of LNG imports.

(29) The Commission considers that the Grain LNG Phase 4 will contribute to the improvement of the UK supply demand balance by increasing the potential availability of non-domestic supplies of gas to the UK, by diversifying the sources of LNG being delivered to the UK and thus increasing the security of supply of the UK and the wider North West European gas market.

(30) Also, the technical capacity of the Grain LNG Phase 4 would improve the operation of the *existing* facilities as it would increase the ability of the UK system to withstand outages in either UK or Norwegian production or operational difficulties in interconnectors.

(31) On this basis, the Commission agrees with the notifying authority that requirements of Article 36(1)(a) Gas Directive relating to enhancement of security of supply due to the investment are met.

5.1.2 The level of risk attached to the investment must be such that the investment would not take place unless an exemption was granted; Article 36 (1) (b) of Directive 2009/73/EC

(32) The Applicant has based its case in relation to the risk of the project on the need to secure long term contracts with the users of the expanded capacity in order to mitigate the risk of non-use of the capacity or of changes in revenues.

(33) In the present case the Applicant has engaged in significant market testing through the Open Season processes. Long term rights have been and will be allocated based on Open Season processes – in line with the need for effective market testing set out in the Commission Staff Working Paper[2] and foreseen in Article 36(6) of the Gas Directive.

(34) According to the notifying authority, the level of risk associated with the investment is such that the investment would not take place unless an exemption was granted. This is because the additional capacity of 8.4 bcm/y of Grain LNG Phase 4 represents a sunk cost as, once invested, the assets cannot be easily redeployed elsewhere.

[2] Commission Staff Working Paper on exemption of new infrastructures (hereinafter "the Commission Staff Working Paper") of 6.5.2009, SEC(2009)642 final, paragraph 28.3 (box).

However, the notifying authority requires un-contracted capacity to be allocated in a fair, non-discriminatory and transparent manner subject to its approval.

(35) As regards the duration of the exemption, the notifying authority has limited it to the period of the initial contracts with primary capacity holders, with the exception of the Tranche A – where the duration is limited to the pay-back period of the whole project (22 years) rather than the length of the contract (25 years). The beginning of the exemption period for each tranche is when that tranche is completed, subject to the requirement that the Grain LNG Phase 4 project to which this exemption decision relates must be operational within five years of the final decision.

(36) Exemptions are designed to allow for investments where the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted. If the investment in infrastructure for gas or electricity is a sunk cost, two main risks determine the assessment: the risk of non-use of the investment and the risk of a change in costs and/or revenues in the future[3].

(37) As regards the risk of non-use, the need to secure upstream supply from capacity users can be relevant in particular for LNG terminals if the upstream suppliers require from infrastructure developers long-term transportation and transmission contracts to conclude supply contracts[4]. It is also accepted that the conclusion of long term contracts under an exemption from regulated Third Party Access provisions can represent an appropriate way of addressing this risk [5].

(38) The Commission can agree that, in view of the circumstances explained by the notifying authority, there is a risk that without the exemption, it would be difficult to ensure an optimal use of the full infrastructure capacity.

(39) Regarding the duration of the exemption, the Commission agrees that separating the exemption into tranches with the duration of the exemption for each individual tranche as set out in the notifying authority's decision appropriately reflects the risk associated with this project.

(40) The Commission also agrees with the notifying authority as regards the limitation of the timing for start of construction and beginning of operation and the condition that all three Tranches of the capacity must be operational within 5 years in that respect.

(41) On this basis, the Commission agrees with the notifying authority that requirements of Article 36(1)(b) Gas Directive, relating to the requirement that the level of risk attached to the investment must be such that the investment would not take place unless an exemption was granted, is met.

5.1.3 The infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built; Article 36 (1) (c) of Directive 2009/73/EC

(42) Grain LNG Phase 4 will be owned by National Grid Grain LNG Ltd, a legal entity distinct from the gas Transmission System Operator in Great Britain, National Grid Gas plc. The Commission therefore agrees with the notifying authority that the requirements of Article 36(1)(c) Gas Directive, under which the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form

[3] *Ibid.*, paragraph 41.
[4] *Ibid.*, paragraph 42.
[5] *Ibid.*, paragraph 42 (box).

from the system operators in whose systems that infrastructure will be built, are fulfilled.

5.1.4 Charges must be levied on users of the infrastructure; Article 36 (1) (d) of Directive 2009/73/EC

(43) According to the notifying authority, the Applicant will charge the primary capacity holders an annual fee for the use of Grain LNG Phase 4 capacity, which will be set out in their long-term capacity contracts with the Applicant.

(44) Thus charges will be levied on the users of the infrastructure and will allow the Applicant to recover the capital and operating costs of the Grain LNG Phase 4 terminal expansion.

(45) In light of this, the requirement of Article 36 (1) (d) of Directive 2009/73/EC is fulfilled.

5.1.5 The exemption must not be detrimental to competition or the effective functioning of the internal market in natural gas, or the efficient functioning of the regulated system to which the infrastructure is connected; Article 36 (1) (e) of Directive 2009/73/EC

(46) The notifying authority imposes a condition on the exemption of Grain LNG Phase 4 whereby the arrangements for making unused capacity available to third parties must be subject to approval and periodic reviews by the notifying authority.

(47) As noted in the Commission Staff Working Paper,[6] this criterion focuses on the impact of the *exemption* on competition and the internal market rather than the infrastructure itself. Of particular importance in this regard is the potential impact that an exemption could have by relieving the capacity holders and the infrastructure operators from the requirement to implement effective anti-hoarding rules. This would undermine the role of the market in driving optimisation, and undermine the benefits to competition from the additional capacity, by allowing it to be withheld from the market.

(48) The Commission supports the approach of the notifying authority to require explicit approval of the implemented mechanisms as a condition of the exemption as it ensures that the exemption is limited to the minimum necessary to allow the investment to proceed. Regulatory approval of such mechanisms does not undermine the conclusion of long term contracts necessary to mitigate risk and facilitate the integration of new supply sources.

(49) The Commission agrees with the notifying authority that the exemption of Grain LNG Phase 4 is not detrimental to competition, provided the new capacity is allocated according to the outcome of the Open Season process and in particular no single prospective user acquires more than two of the three Tranches. In this regard, the notifying authority has indicated that should the final result of the Open Season be materially different from that submitted by the Applicant, it will reserve the right to reconsider the exemption decision. The Commission can accept such reservation, provided the notifying authority consults it again on any proposed material changes in respect of the exemption.

(50) As regards the functioning of the internal market, the Commission does not anticipate any negative effects of the exemption on the overall energy network in the EU or a cross-border trade in gas between the UK and the Continent.

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6 *Ibid*., paragraph 60.

(51) In light of the above, the Commission is confident that the exemption will not be detrimental to competition or the effective functioning of the internal market, and believes that the requirements of Article 36(1)(e) Gas Directive are fulfilled.

HAS ADOPTED THIS DECISION:

Article 1

The Commission considers that the Office of Gas and Electricity Markets decision of 8 March 2013 to grant an exemption to Grain LNG Phase 4 in accordance with Article 36 of Directive 2009/73/EC meets the requirements of that Article and the exemption can be granted under the conditions specified in the decision. The Office of Gas and Electricity Markets may therefore confirm its decision.

Article 2

In line with Article 36(9) of Directive 2009/73/EC, the Commission's approval of this decision shall lose its effect two years from the adoption of this decision in the event that construction of the infrastructure has not started and five years from its adoption in the event that the infrastructure has not become operational unless the Commission decides that any delay is due to major obstacles beyond control of the person to whom the exemption has been granted.

Article 3

This Decision is addressed to the Office of Gas and Electricity Markets, 9 Millbank London SW1P 3GE.

Done at Brussels, 4.6.2013

For the Commission
Cecilia Malmström
Member of the Commission

CERTIFIED COPY
For the Secretary-General,

Jordi AYET PUIGARNAU
Director of the Registry
EUROPEAN COMMISSION