EXPLANATORY MEMORANDUM TO

THE GAS ACT 1986 (EXEMPTION) ORDER 2005

2005 No.16

1. This explanatory memorandum has been prepared by Department of Trade and Industry and is laid before Parliament by Command of Her Majesty.

2. Description

2.1 The Order exempts persons conveying gas from Liquefied Natural Gas (LNG) import facilities to a pipeline system operated by a licensed gas transporter, or to premises associated with an LNG import facility, from the requirement to hold a Gas Transporter licence. It also exempts from licensing the conveyance of gas from a ship and a licensed gas transporter's pipeline system to an LNG facility and associated premises and the supply of gas to the facility and associated premises. These exemptions will facilitate development of energy infrastructures at a time when the UK is becoming increasingly dependent on imported gas.

3. Matters of special interest to the Joint Committee on Statutory Instruments *or* the Select Committee on Statutory Instruments

3.1 None

4. Legislative Background

4.1 Section 5 of the Gas Act 1986, prohibits the unauthorised conveyance of gas through pipes otherwise than by means of a gas interconnector by a person who conveys gas through pipes to premises, or to a pipe-line system operated by a gas transporter. It also prohibits the unauthorised supply of gas to premises. However, this would be a regulatory burden on those engaged in these activities in relation to LNG import facilities . There are already other similar Orders in place exempting operators of certain terminals and storage facilities from holding a Gas Transporters Licence (see S.I. 1996/471 and S.I. 1999/2639). In making this Order the Secretary of State exercises her powers under section 6A of the Gas Act 1986 (the Act), as she has done in relation to previous exemption orders.

4.2 The Secretary of State's power to grant this Order is exercised in accordance with the principal objective and general duties under Section 4AA of the Act to 'protect the interests of consumers'. The aim of this Order is to contribute to the successful development of the UK gas market by removing potential barriers to entry.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

Not applicable

7. Policy background

7.1 The Secretary of State's obligation under section 4AA of the Act is to protect the interests of consumers in relation to gas conveyed through pipes, wherever appropriate, by promoting effective competition. The Order will contribute to this objective by aiding the successful development of the GB gas market by removing potential barriers to entry.

7.2 The policy objective of this Order is to minimise regulatory burden and reduce regulatory costs on persons supplying gas to LNG import facilities and associated premises and conveying gas to and from LNG import facilities. This is aligned with the overall objective as laid out in Chapter 6 of the Energy White Paper "Our energy future - creating a Carbon Economy"(Cm 5761) to improve energy reliability by securing diversity of gas supplies at time when the GB is becoming increasingly import dependent.

7.3 It is expected that the GB will become a net importer of gas on an annual basis in 2005. The first LNG import infrastructure project is expected to flow gas in early 2005, and would contribute to easing a potential for tight gas supply during the next two winters. There are two further planned LNG projects in the public domain – together, the three projects could supply gas in excess of 25% of total GB gas demand by 2020.

7.4 The requirement to hold a Gas Transporter's Licence is likely to increase the regulatory burden on the three planned LNG projects, and may increase the costs associated with complying with this regulatory regime. In the extreme, this may deter LNG importers from entering the GB gas market, and therefore the ability of GB to access marginal sources of gas during periods of peak demand or tight supply. All three LNG import facilities have expressed concern about the regulatory burden and the costs of obtaining and renewing a Gas Transporter's Licence.

7.5 The Order effects a technical change which has attracted limited public interest. It extends to operators of LNG import facilities a deregulatory policy which has already been effected in relation to operators of certain other kinds of gas supply infrastructure (see paragraph 4.1 above).

7.6 There were 9 responses to the public consultation. All were from industry participants or Ofgem. All respondents agreed with the principle that LNG import facilities should be exempt from the requirement to hold a gas transporters licence, and that this would reduce the regulatory burden on these facilities, and encourage the construction of future energy infrastructure.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum

9. Contact

Rachel Egan at the Department of Trade and Industry Tel: 0207 215 5176 or e-mail: Rachel.Egan@dti.gsi.gov.uk can answer any queries regarding the instrument.

Department of Trade and Industry

FINAL REGULATORY IMPACT ASSESSMENT

To Make An Exemption From The Requirement For A Gas Transporter Licence In Respect of Liquefied Natural Gas Import Facilities and the requirement for a supply licence in relation to the supply of gas to such facilities and associated premises

PURPOSE AND INTENDED EFFECT OF THE MEASURE

(a) Objective

The overall policy objective is to improve energy reliability by securing diversity of gas supplies at a time when the UK is becoming increasingly import dependent.

The objective of this order is to minimise regulatory burdens and reduce regulatory costs in relation to existing and possible new Liquefied Natural Gas (LNG) import facilities. The intention is to exempt persons conveying gas to these facilities and associated premises, and from these facilities, from the requirement to hold a Gas Transporter (GT) licence, and persons supplying gas to these facilities and associated premises from the requirement to hold a supply licence, by making an order.

(b) Background

Chapter six of the Energy White Paper "Our energy future – creating a low carbon economy" (Cm 5761) details the Government's commitment to energy reliability. It states that the Government's goal is to ensure that 'people and businesses can rely on secure supplies of energy – gas…' and to achieve this by ensuring diversity of sources and having robust infrastructures in place.

Currently there are three planned LNG import projects (in the public domain) - together, the three projects could supply 25% of total GB gas demand by 2020. These projects are seeking an exemption from the requirement to hold a GT licence for the conveyance of gas to the National Transmission System (NTS).

The Gas Act 1986, as amended, requires a person to be licensed as a gas transporter ("GT") if he "otherwise than by means of a gas interconnector conveys gas through pipes to any premises, or to a pipeline system operated by a gas transporter". This means that the operator of a LNG import facility, which feeds into Transco's system, would require a GT licence unless he benefited from an exception in the Act or an exemption order.

The Secretary of State may exempt a person from the licensing requirement, following consultation with the Gas and Electricity Markets Authority (the Authority) and the Gas and Electricity Consumers Council. She also has to publish her proposal in a manner likely to bring them to the attention of those likely to be affected by them. The power is exercisable by means of an order (subject to negative resolution procedure).

Exemption orders are deregulatory.

RISK ASSESSMENT

The requirement for a GT licence would be likely to increase the regulatory burden on the three new proposed LNG import facilities and possible future projects. The risk of increasing the regulatory burden is the increase in costs associated with complying with the existing regulatory regime. In the extreme it may deter LNG importers from entering the GB gas market, thereby reducing marginal sources of gas during peak demand. All three LNG import facilities have expressed concern about the regulatory burden and costs of obtaining and renewing a GT licence and hence have sought an exemption.

The Joint Energy Security of Supply group (JESS), comprising officials from DTI and the Office for Gas and Electricity Markets (OFGEM), has published a report[1] which suggests that from 2005/06 the provision of sufficient supplies to meet peak gas demand during a 1 in 50 winter[2] will partly be dependent upon the timely construction of new infrastructure projects. This scenario is extreme.

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[1] Joint Security of Supply Working Group (JESS) Fourth Report November 2004
[2] This is a severely cold winter such as would occur once in 50 years.

However, the report is based on Transco's 2004 supply and demand forecast and combines the latest developments in planned gas infrastructure.[3] The key point to note is that the earliest of the LNG import facilities (due to come on stream in early 2005) has been included in the planned gas infrastructures.

Where there are delays in new projects coming forward or, at the extreme, a reduced number of new entrants, there are a number ways in which increasing regulatory burdens on LNG import facilities could affect the GB gas market in the short term and long term:

Short Term:
- Reducing marginal sources of gas – there might be very high price spikes as demand exceeds supply on peak demand days in winter;
- Generally increased gas prices for industrial and domestic customers if import projects deadlines are not met due to regulatory burdens;
- Reduction in security of gas supplies as existing sources of gas decline;
- There could be increases in electricity prices if gas–fired power stations could not be supplied with sufficient gas.

Long term:
- Reduce diversity of gas supplies - the very nature of LNG (in liquid form as opposed to gaseous form), provides increased flexibility in its method of transport. This flexibility allows LNG to be transported in tankers from (e.g.) Qatar or Algeria to GB directly;
- Reduce diversity of gas transportation methods;
- Possibly deter future import projects;
- Reduction in security of gas supplies;
- Reduction in competition.

These are worst-case scenarios of the potential risks, but they need to be considered against the background of JESS's assessment of how much gas will be required when we become more reliant on imported gas.

We recognise that the cost and burden of exemptions are only one element in the overall decision to invest in LNG import facilities. However, making an exemption order could improve competition in the gas market, security of supply, diversity of supply, and reduce costs to domestic and industrial consumers.

OPTIONS

Option 1 - No change – Not make an exemption from the requirement for a gas transporter licence for persons operating LNG facilities.

Option 2 - To exempt named LNG import projects seeking an exemption from the requirement for a gas transporter licence in respect of LNG import facilities.

The exemption would have the following conditions on information:

- A reserve power (as in SI 1999/2639) for the Secretary of State to direct the disclosure of information to a relevant gas transporter of operational information and capacity information pertaining to the next following day;

- A reserve power to enable the Secretary of State to direct the disclosure to a relevant gas transporter, the Secretary of State, the Authority or the HSE of such information concerning the LNG import facility relevant to the operation of the pipeline system operated by a gas transporter as may be in the direction.

- A reserve power to enable the Secretary of State to direct disclosure to the Secretary of State and the Authority of capacity information: the location, commissioning date, and operational capability of relevant LNG import facilities, and details of any subsequent significant changes in operational capability.

[3] Based on theoretically maximum level of demand, rather than forecast of actual demand.

The exemption would also include conditions on supply and conveyance. This would enable the LNG facility to convey gas around the site, for its own use for running the site. The exemption would also cover any supply of liquid gas with boil-off gas coming on the site and include the conveyance of boil-off and reject gas off the site to a licensed network. Also covered would be the gas conveyed for electricity generation on or off site, providing the electricity is only exported for use on the site. The plant would not be able to export any excess electricity to the grid or a third party (though there are no restrictions on the supply of co-generated heat).

Option 3 *- To make a "class" exemption (to exempt all operators of LNG import facilities) from the requirement for a gas transporter licence. The proposed exemption would have the same conditions as option 2.*

COSTS AND BENEFITS

(**a) BENEFITS**

Option 1

One possible benefit of having a GT licence is that it could confer advantages in relation to land right/acquisition in some circumstances. This could be a benefit in relation to construction of the facility. The LNG import facilities would be regulated by Ofgem, who ensure that the facilities comply with the conditions in the GT licence.

Information

The information provisions in the GT licence would cover information provided to the Authority; supply point information service; the provision of information relating to gas illegally taken and information to be provided to the Designated Registrar of Pipes.

Safety

Current conditions on safety, in health and safety legislation would apply and be regulated by HSE.

Option 2

By exempting named LNG import facilities DTI could consider each application for an exemption individually. If an LNG facility can make a reasonable case for an exemption it can be added to the Order. This would encourage possible LNG import projects to come forward earlier and would enable DTI to advise them as necessary.

Financial

Facilities that would be exempt by the proposed order would reduce their regulatory burdens and save costs associated with applying for a GT licence. They would also save on internal administration costs arising from the requirement to hold a GT licence. The initial costs could be up to £100,000 (including legal expenses) in obtaining a gas transporter licence and preparing a network code, though one respondent to the consultation indicated that this initial cost might be higher. A network code is the commercial arrangement between a gas transporter and shipper, who arranges for the conveyance of gas through the gas transporter's pipeline system. The annual administration and other costs thereafter could run into tens of thousands of pounds.

The advantage to third parties (e.g. Shippers) is that they would not be required to hold a shipper licence in order to enter commercial arrangements to convey their gas through the LNG import facilities.

Social

The benefit of removing regulatory burden is that costs of gas would be lower and we would be encouraging/facilitating players to enter the GB gas market. This may have the positive impact of lowering gas (and possibly electricity) prices for industrial and domestic consumers. We would also be increasing diversity of gas sources and encourage diverse methods of gas supplies into GB (i.e. using tankers as well as gas pipelines). Both are important to improving security of supply into GB.

Environment

A further benefit of encouraging more gas supplies into GB is that burning gas, rather than coal and oil, produces less carbon dioxide and other gases affecting air quality. As the Government is committed to reducing key emissions, the exemption would indirectly contribute towards meeting this commitment.

Exemption Conditions

(i) Information

The benefits of having the reserve powers as in SI 1999/2639, and an additional power extending the type of information to be disclosed to relevant parties (if the need arises), are that it would:

- broaden the parties to whom the information may be disclosed;
- extend the type of information that may be requested;
- allow the department to respond to an urgent request for a particular type of information in a "security of supply" emergency;
- Help the functioning of the market, for example, in terms of price, investment and security of supply.

(ii) Supply and conveyance

Government believes that an exemption under section 5 of the 1986 Gas Act would enable LNG facilities to use their own gas on their site and thereby avoid the cost/regulatory burden of the gas producers supplying LNG needing to acquire a gas supply licence. The exemption for the generation of electricity on-site (or off-site) where that electricity is only used on-site to run the facility only would ensure a level playing field in this respect across all LNG facilities.

Option 3

Option 3 would include operators of all LNG import facilities. Therefore the benefits mentioned in option 2 would apply to the current proposed LNG import facilities as well as possible future facilities.

(B) COSTS

Option 1

A GT licence has numerous conditions. One condition is for the gas transporter to prepare and maintain a network code. If LNG facilities were required to have a GT licence, this may place them at a competitive disadvantage to other entry terminals and interconnectors.

Financial

There are costs associated with applying for a licence from the Office of Gas and Electricity Markets (OFGEM) and renewing this licence on an annual basis, as well as preparing and maintaining a network code.

The costs associated with a gas transporter licence are estimated to be as follows (though one respondent considers them to be an underestimate of the true costs):

- the application fee is £3,000, and there is an annual fee of £4,000, payable to Ofgem;
- initial internal administration costs arising from obtaining a gas transporter licence and preparing a network code (including legal expenses) could be up to £100,000;
- annual administration and other costs thereafter could run into tens of thousands of pounds.
- administrative costs on Ofgem, who are responsible for issuing the gas transporter licences.

Currently Transco's GT licence has an information disclosure provision. It is proposed that this will be modified as part of the offshore information exercise. As this is an on-going exercise the costs have not yet been analysed.

Social and Environmental

The extent to which there are social and environmental costs in terms of the issues discussed in the risk assessment, is dependent on the response of LNG import facilities to social and environmental factors (i.e. market dependent). If option 1 slows the import projects from entering the GB gas market there may be costs in relation to competition in price terms, to security of gas supplies and to environmental costs.

<u>Option 2</u>

Financial

It could be argued that the named facilities would be automatically exempt and therefore not incur any costs and that the costs that may be incurred under option two are public sector costs. However, one respondent to the consultation indicated that the initial one-off cost to a firm of an exemption would be similar to that of obtaining a licence (£100,000). Each LNG import project would need to be considered individually. If we did add them to a list in the proposed exemption order we would be required to undergo a consultation process in every case. This would be an onerous and process driven burden. Based on the work done to lay previous exemption orders we estimate the cost of laying an order to be approximately £100,000. This would apply each time we amended an exemption order.

Proposed Conditions

<u>Information</u>

We do not envisage that the information provision in the proposed exemption order will be more onerous or costly than that required under the current licensing and exemption orders. This is because the information we may require will already be available to the companies. We believe this also to be the case for the additional reserve power we have proposed in the information condition. We would engage in non-statutory consultation, possibly including written consultation and a RIA in non-urgent cases.

<u>Gas supply and conveyance</u>

We do not envisage any costs arising from this provision. None was suggested by consultation respondents.

<u>Option 3</u>

There would be no costs to the operators of LNG facilities, as they would be automatically exempt. However, we would incur one-off Public Sector costs of approximately £100,000 to go through the consultation process and lay the proposed exemption order.

Information provision and gas supply and conveyance
Please see discussion on costs of these provisions above, under option 2.

BUSINESS SECTORS AFFECTED

The firms that would be affected are the three proposed large LNG import facilities who are seeking an exemption order. In the future owners of other LNG facilities will also be affected.

Shippers who use the LNG import facility to ship their gas will also be affected insofar that they would not require a shipper licence under Options 2 and 3. Similarly, the gas supply and conveyance condition will mean that the LNG producers would not require a gas supplier licence.

Inasmuch as the costs of an exemption are lower than those for a licence the overall cost of gas to industrial and commercial users will be lower.

EQUITY AND FAIRNESS

Based on the 2001 English House Condition Survey data, it is estimated that there are some 1.4m gas users in the UK who are "fuel poor" – have to spend at least 10% or their income on heating their home to an adequate level. This means that consumers classified as fuel poor will be particularly adversely affected by any increase in energy prices. We have mentioned above that increasing diversity of gas supplies may maintain or lower gas (and electricity) prices.

Currently most of the gas into the GB enters terminals in the North and East of the country. In periods of peak demand (these are extreme cases), where gas is required in the West of the country, the gas needs to be transported to the affected areas. Two of the three LNG import facilities currently being constructed are in Wales. This means that the gas from these facilities would be able to supply the local network in such extreme cases.

SMALL FIRMS' IMPACT TEST

The LNG companies who would be directly impacted by the proposed exemption order are large companies. We have consulted trade associations on whether small companies would be affected directly or indirectly. They do not believe that there would be a negative impact on them.

The deregulatory Options 2 and 3 will have a positive impact on Shippers (some of these may be small firms) as they will not be required to hold a Shipper licence.

COMPETITION ASSESSMENT

This measure will affect potential Liquefied Natural Gas (LNG) import facilities.

The market can be defined as the provision of import services to gas producers and UK gas shippers (the latter act as intermediaries between gas producers and gas suppliers and arrange for the gas to be transported in pipes around the UK). LNG import facilities, where LNG is imported by tankers, will compete with gas terminals where the piped gas from offshore oil and gas fields and from other countries is landed. For shippers, this competition is direct as they can potentially buy gas brought in from any terminal. For producers, this competition may be direct, e.g. where LNG can be regasified at Zeebrugge and brought into the UK via the interconnector to Bacton (see next paragraph) or indirectly through a geographical chain of substitution.

Market structure
There are 9 principal UK gas terminals several of which consist of separately operated co-located sub-terminals. These are in diverse ownership with major interests from the key gas producers, such as Shell, ExxonMobil, Total and BP; most (sub-) terminals have shared ownership. In broad terms, some two-thirds of gas entering the UK currently flows through two of them, St Fergus in Scotland and Bacton in East Anglia; each of these facilities, consisting of various sub-terminals, is jointly owned by major gas producers.

New entry
Three LNG import facilities are being built/planned and there may be others forthcoming. Together, the three new LNG facilities could supply gas in excess of 25% of total GB gas demand by 2020 (with supplies through most of the existing gas terminals expected to decline rapidly as production of gas from the UK continental shelf falls off over the next few years) - one of these import facilities is owned by ExxonMobil which also part-owns sub-terminals at both St Fergus (two, one of which it operates) and Bacton. A new terminal at Easington is separately expected soon to have the capacity to import from Norway another 20% of (annual) UK gas demand.

Potential impact on competition of the three options
Option 1 would require new LNG import facilities to obtain a licence. Existing players in the market (see definition above) do not face this cost, thus there is a differential effect on firms and, at the margin, the requirement may represent a barrier to entry. Options 2 and 3 remove this licensing requirement and hence are likely to be pro-competitive inasmuch as they will match this aspect of the regulatory regime (and its cost) for new LNG import facilities with that of the gas terminals[4].

However, it is judged that the level of costs of Option 1 (one-off cost of £100,000 and ongoing costs of tens of thousands of pounds) would be low relative to the total cost of setting up and running an LNG facility (set up costs might be in the region of tens of million of pounds), and as such would not deter/delay entry, except at the margin. Similarly, it would not significantly affect some firms more than others, change the market structure, or affect the ability of firms to choose their price, location or service.

On balance it is considered that the preferred option, Option 3, is pro-competitive but that the degree of the impact on competition from any option is likely to be limited.

ENFORCEMENTS AND SANCTIONS

Under option 1, the LNG import facilities would be required to apply for a GT licence and consequentially be required to maintain a network code. As Ofgem is the regulator of downstream activities, it would enforce the licence conditions and the network code. It also falls into Ofgem's remit to sanction any amendments to the licence conditions or the network code.

Options 2 and 3 may have conditions on information, which may be enforced on direction by the Secretary of State for the DTI. Safety would be enforced by HSE (though note that there are no safety provisions imposed in the Order).

MONITORING AND REVIEW

We will review all current gas exemption orders with an expiry date of 01 March 2011 in good time. The proposed exemption order would also be reviewed at the same time.

[4] If the reserve powers under option 2 and 3 are invoked we would, at that time, engage in non-statutory consultation, possibly including written consultation and a RIA in non-urgent cases. Such an impact assessment would include an analysis of the impact on competition resulting from the provision of the information.

RESULTS OF THE CONSULTATION

A partial RIA accompanied the formal public consultation document in September. Prior to this DTI had talked informally to key stakeholders in industry and Government and their views have informed this work.

There were nine responses to the formal consultation in September. All respondents broadly agreed with the principle that LNG import facilities should be exempt from the requirement to hold a gas transporter licence. All nine also generally agreed that this would reduce regulatory burdens on these facilities. The majority of the respondents also concurred that reducing regulatory burdens in this manner encouraged the construction of future energy infrastructure. This is in line with the intention of mitigating the long term and short risks, as identified above, associated with competition in the gas market, security of supply, diversity of supply and potential reduction in costs to domestic and industrial customers.

Most respondents agreed with the analysis in the RIA. One respondent, however, felt that a licence would not assist in respect of planning and it should not be counted as a benefit of option 1. Another respondent thought that the estimates of costs for all the options were too low - no further data were provided. One respondent did not think that any small shippers would be affected by the exemption.

Based on the responses, the Department is content that the principle of the proposed Order is not challenged. After careful consideration of all responses the Department's view is that it should implement the proposed Order. The proposed Order has taken into account amendments that the Department considers reflect policy intentions more clearly. These amendments include:

- an exemption on supply and conveyance so that LNG facilities can use their own gas on their site. This avoids the cost/ regulatory burden of needing to acquire a gas supply licence.
- An exemption on conveyance of gas through pipes from a ship so that vapour gas is covered
- an exemption for conveyance of gas from the facility to a generating station where that electricity is solely used on site. This will ensure a level playing field in this respect across all LNG facilities.

These amendments are considered to be sufficiently minor not to require the Order to be consulted upon again.

RECOMMENDATION

Option 3, a class exemption, should be taken forward. This reduces the risks to security of supply as spelt out in the Risk Assessment above; it achieves the benefits of avoiding costs of licensing; and it is the least cost option (for both firms and the public sector). The exemptions put forward on gas supply and conveyance will further reduce the costs of the LNG facilities. The information provision is not considered to be costly to firms and it will allow the Department to respond to an urgent request for a particular type of information in a “security of supply” emergency and help the functioning of the market, for example, in terms of price, investment and security of supply.

MINISTERIAL SIGN-OFF

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs

Signed by Mike O'Brien, Minister for Energy and E-Commerce

Mike O'Brien.

10th January 2005

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