Investments and Uncertainty in Liberalised Gas Markets: do projects need Article 22 exemptions?

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Agenda

- Investments in liberalised gas markets: traditional arguments
- Article 22 exemptions
- Investments in the British gas market
- Ormen Lange and the North European Pipeline
- Conclusions

Investments in Liberalised Markets: some traditional arguments

- Investors must have a regulatory environment which gives them certainty over the life of the asset otherwise….
- Large scale – multi-billion euro – investments will not be made and that means..
- Supply will not arrive in the market in a timely fashion and so..
- Security will be threatened

Long term take or pay contracts are the best means to achieve long term large scale investment; these are threatened by EU competition authorities

Investments in Liberalised Markets: more traditional arguments

- Bankers require long term take or pay contracts in order to advance funding for projects
- Increased regulatory risks in liberalised markets will:
  - increase the cost of borrowing and therefore
  - make it less likely that projects can obtain funding and therefore
  - producers will be reluctant to develop new greenfield projects

Traditional arguments were more convincing at an early stage of market development; now sound more like reluctance to take risk and defence of monopoly/monopsony positions

Article 22* Exemptions from Access

Grounds for exemption under Article 22:

- "major new infrastructure" eg interconnectors between Member States; LNG facilities, storage facilities - Article 22(1)
- Must enhance competition in gas supply and security of supply
- Level of risk must be such that the project could not go ahead without an exemption
- Must be legally separate from the system operator
- Charges must be levied on users
- Exemption must not be detrimental to the efficient functioning of the internal market or the regulated system to which the project is connected

*Directive 2003/55/EC

Estimated Investments for New UK Gas Projects

- Ormen-Lange $10bn (total incl. upstream)
- Interconnector expansion ~$0.25bn
- Bacton-Balgzand BBL $0.5bn
- Isle of Grain Train 1 (terminal only) ~ $0.2bn
- Dragon LNG (terminal only) ~$0.3bn*
- Qatargas 2 (terminal only) ~ $0.5-1.0bn**
- North European Pipeline $5-7bn (pipeline from Russia to Germany only)

Arbitrage potential of LNG projects

~ authors' estimates, *train 1 only; **1 or 2 trains

Most New Projects Have Requested Article 22 Exemptions

Ofgem has granted (subject to EU approval):

- South Hook (Qatargas) LNG exemption for the totality of the capacity
- Dragon LNG exemption for the totality of the capacity
- Grain LNG: exemption likely to be granted
- BBL – 15 year exemption

With provisos:

- Should conduct open season
- Use it or lose it
- Information provision to Ofgem

Except Ormen Lange (and IUK Expansion)

The Ormen Lange Field and Langeled (Britpipe) Pipeline to the UK

- Deliveries: 20-24 Bcm/yr
- Total investment: $8-10bn
- Lead time: pipeline - 3 years; field – 4 years
- Equity partners: Norsk Hydro (operator in 1st phase) 18%, Shell (operator in production phase) 17%, BP 10.9%, Statoil 10.9%, Exxon 7.2%, Petoro 36%
- Development is under way. Centrica/Statoil is the only long term contract. Sellers intend to:
- Develop a portfolio of long, medium, short term sales and possibly…
- Arbitrage between the UK and Continental European markets

Ormen Lange: reasons for investors and lenders to be relaxed about *gas supply* contracts

- Selling into the largest, liquid market in Europe
- UK market is running short of gas and will need substantial new supplies
- Most equity holders have market operations in the UK and customers on the Continent which give them..
- Arbitrage possibilities
- Recognition that Ormen Lange will be among the lowest cost sources of gas in the UK

Market and project fundamentals provide certainty

Ormen Lange: reasons for gas sellers and lenders to be relaxed about long term *transportation contracts*

ALL ORMEN LANGE SELLERS WILL NEED LONG TERM TRANSPORTATION RIGHTS IN BRITPIPE AND LONG TERM ENTRY CAPACITY TO THE UK NETWORK AT EASINGTON BUT:

- Norwegian offshore capacity regime is well established
- British entry capacity auctions are well established

Long term contracts guarantee market access, not sales or prices

North European Pipeline – financing issues

- Significant investment - up to $7bn
- "Greenfield" project which cannot be built in stages with very few markets along the route
- High cost gas: at least $3 (possibly $3.50)/mmbtu delivered to Germany – cost in UK??
- NEP will need to be legally unbundled with long term capacity contracts and purchase contracts

Significant risk of selling high cost gas into a liberalised market; NEP has a good case to receive an exemption

Investments and Uncertainty in Liberalised Markets: do projects need Article 22 exemptions?

- Some projects seem as if they will receive exemptions: BBL, Dragon LNG, South Hook LNG, Grain LNG
- Some have not asked for exemptions: IUK, Ormen Lange
- Some will need exemptions: North European Pipeline

The case for exemptions needs to be demonstrated on a project-by-project basis