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