

Energy

Energy Markets

Hedging Gas Supply Risks: Are LNG Terminals the Answer?

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With natural gas consumption predicted to rise greatly in Europe over the coming decades, and production of natural gas declining, this article briefly looks at the impact of liquefied natural gas (LNG) terminals on the natural gas markets, and considers the open access issues that remain in relation to LNG terminals, in order for there to be more scope for competition between LNG and traditional pipeline gas.

Natural gas consumption and demand for LNG

The use of natural gas continues to rise sharply, particularly due to increased demand for combined cycle power generation to meet Europe's growing electricity consumption. The benefits of using natural gas in power generation stem primarily from the fact that gas-fired power plants emit less carbon dioxide emissions (CO₂) and are more flexible than traditional coal-fired plants.

With natural gas production in many European countries declining (the UK, for example, is now a net importer of gas), many countries are looking at LNG as a means for diversification, as security of energy supply is becoming increasingly important. Security of supply is an acute concern for Northern European countries such as the UK, the Netherlands and Germany, which receive the bulk of their gas needs from Russia and the North Sea.

Historically, the LNG market in Europe has been restricted by a lack of re-gasification capacity and infrastructure. However, there have been a number of LNG terminals that have been proposed in recent years, including the South Hook terminal at Milford Haven in the UK, with fourteen terminals already operational in Europe.

In order to liberalise the European gas markets, the European Commission began a process in the early 1990s of introducing a number of measures aimed at creating greater competitiveness in the gas markets, creating security of supply and ensuring sustainability. In [Directive 2003/55/EC](#) (Second Gas Directive), the Commission introduced measures requiring Member States to provide open access to gas infrastructure, which included LNG terminals.

The Second Gas Directive required Member States to introduce a system of regulated Third Party Access (rTPA) to LNG receiving terminals, *i.e.*, access to LNG terminals is treated in the same way as access to the gas transmission network. However, developers of new import facilities and enhanced existing import facilities may obtain an exemption from rTPA based on certain conditions.

Third Party Access Issues

There have been differing approaches to the TPA regime under the Second Gas Directive that have been taken by Member States. Neither Spain nor France, for example, has made use of the possibility for an exemption to the rTPA regime, whereas Italy, the UK and the Netherlands have made the application for such an exemption a possibility.

Five LNG terminals have applied for exemptions so far in Europe: in Italy, the Rovigo and Brindisi terminals, and in the UK, the Grain LNG, South Hook and Dragon terminals. Grain LNG has been developed to provide access to third parties, through a system of bilateral negotiations, *i.e.*, negotiated Third Party Access (nTPA). The other four terminals mentioned above have been developed under an "own use" model, whereby the owners have primary capacity rights, while the secondary capacity is negotiated with third parties.

Therefore, as well as the distinction between Member States opting for or against the availability of exemptions for LNG terminal developers, we have seen that, in countries where the exemptions are available, there is

a further distinction in the rationale for requesting an exemption from the broader rTPA; in the case of Grain LNG, presumably so that the regulated capacity procedures did not impact on the rights of the plant owners to devote capacity to their own use, and in the case of the other terminals, presumably so that lower levels of regulation promote the ability of the plant owners to sell capacity more easily to secure commitments to underwrite project investment.

Furthermore, another issue that arose following the implementation of the Second Gas Directive is that the exemption criterion is open to several interpretations concerning two of the fundamental principles of the Second Gas Directive: competition and security of supply. Ofgem in the UK for example, has considered that the minimum criteria for exemption are as follows:

- A sufficient amount of capacity to be offered to the market;
- Effective mechanisms to ensure that capacity is not hoarded (*e.g.*, use it or lose it (UIOLI) arrangements and secondary market mechanisms); and
- Procedures for information dissemination to the market and to the regulator.

So what have been the practical consequences of Member States taking a different approach to not only whether an exemption to rTPA should be provided, but the circumstances under which such an exemption is granted? Several factors emerge:

- Competition in capacity is heavily restricted in rTPA regimes where there are fewer third party users (Spain is an exception to this as, despite not taking recourse to the exemption route, it has found other means of securing investment and having multiple users of LNG terminals).
- The differing approaches to the rTPA regime and use of exemptions seem to hang on the sophistication of the local gas markets, and corresponding levels of competition.

- LNG terminal operators generally are affiliated to transmission system operators
- The contribution of LNG to gas competition appears limited by the number of users with subscribed long-term capacity.
- The benefits of diversification of supply sources are not always apparent. Exempted systems appear to achieve diversification only across terminals given affiliation of promoters/ capacity holders with producers.
- Affiliation of operator and users in many cases may reduce transparency.

Conclusion

The differing rules concerning the open access issues discussed above continue to impact the speed at which a single European gas market can be accessed. Therefore, in the short-term, we are likely to see that a combination of the costs of handling LNG and the need for project financing for LNG terminals, likely remain somewhat hindered by the different TPA regimes, which further will be compounded by competition for LNG from the Asian markets. The fundamental problem that arises from this is that liquidity in the LNG markets will not be easily achieved in order to create a true spot market.

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