NOTE OF DG ENERGY & TRANSPORT ON DIRECTIVES 2003/54-55 AND REGULATION 1228\03 IN THE ELECTRICITY AND GAS INTERNAL MARKET

THIS DOCUMENT IS NOT BINDING ON THE COMMISSION

EXEMPTIONS FROM CERTAIN PROVISIONS OF THE THIRD PARTY ACCESS REGIME

30.1.2004

Background

The new package, for both electricity and gas, allows for the possibility of exceptions to general rules of third party access contained in the Directives[1] and Regulation[2]. In particular, Article 7 of the Regulation and Article 22 of the new gas Directive suggest that:

> *New direct current interconnectors... and significant increases of capacity in existing interconnectors.... [and major new gas infrastructures, i.e. interconnectors between Member States, LNG and storage facilities], may, upon request, be exempted from the provisions of Article 6(6) of the Regulation and Articles 20 and 23(2), (3) and (4) of the new electricity Directive [Articles 18, 19, 20, and 25(2), (3) and (4) of the new gas Directive].*

The possibility for such exemptions is clearly an exception to the general rule of third party access which is the basis of the new competitive market for electricity and gas. Exemptions will therefore only be granted exceptionally and on a case-by-case basis. There will be no block exemptions for specific types of infrastructure and all cases will be assessed on their merits. This consideration is particularly relevant since there is no possibility of exemptions for existing infrastructure and therefore any decision to give new pieces of infrastructure a different status must be clearly justified.

In general, it will be expected that exemptions cannot apply where an existing dominant position is created or reinforced or where the granting of an exemption reduces the scope for diluting existing dominant positions. Similarly an exemption will not normally be considered where there is little chance of a similar competing piece of infrastructure

---

[1] Directive 2003/54/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in electricity and repealing Directive 96/92/EC (OJ 2003 L 176/37); Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in gas and repealing Directive 98/30/EC (OJ 2003 L 176/57).

[2] Regulation (EEC) No 1228/2003 of the European Parliament and of the Council on Conditions for Access to the Network for Cross-Border Exchanges in Electricity (OJ 2003 L 176/1).

being constructed which would provide a similar function, whether for geographical, engineering or economic reasons.

Normally it will be expected that developers seeking exemptions will have, as far as possible, given other parties an opportunity to gain access to the new facility at the planning and feasibility stage, for example through an open season procedure. Alternatively, developers should create the possibility for a minimum level of third party access to the new infrastructure under the rules of the Directive for a certain proportion of its capacity.

Finally, the scope and duration of the exemption should be proportional to the objective being pursued. The granting of an exemption by regulators or Member States will be motivated by their desire to protect customers against having to underwrite projects where the ratio of benefits to costs is uncertain and where the cost is particularly high. The details of the exemption to be awarded should therefore be in proportion to these parameters.

What Constitutes New Major "High Risk" Infrastructure

For the purposes of the exemption decision, the following criteria are relevant when deciding what constitutes "new major infrastructure".

A new piece of infrastructure (or significant increase to the capacity of existing infrastructure) is a project for which the main financial commitment to construction will be made after the date of publication of the new gas Directive and the electricity Regulation; that is to say 15 July 2003.

For gas, such exemptions must be immediately notified to the Commission. For electricity, exemptions granted between 15 July 2003 and the entry into force of the Regulation on 1 July 2004 must be notified to the Commission immediately after that date. For existing investments, either electricity or gas, i.e. those for which the main financial commitment was made before 15 July 2003, no exemptions may be awarded.

A "major" or "high cost" piece of infrastructure in the sense of the legislation is a project which, including all its component parts would, if underwritten by regulated tariffs, significantly increase final customers' bills. An example of a suitable rule of thumb might be that to be defined as a "major investment", the project would have a capital cost of more that €10 per connected customer.[3]

A risky investment, for the purposes of the exemption, is one where at least:

- the investment concerned is a sunk cost in that the asset concerned cannot be recovered and re-used for another purpose other than its original one, and

- where the projected benefits of the investment to consumers as a whole is difficult to evaluate due to the range of possible events that might occur subsequent to the investment being committed; examples include, variations in consumption projections, other alternative competing investments being made, changes in world market conditions for primary fuels or an above average amortisation period for such type of investment.

[3] Therefore, if the project costs were to be passed onto 20 million households through transmission tariffs, this amounts to a threshold of some €200million to be considered a "major" project.

Special treatment without exemption

Before considering when the exemptions are justified it is necessary to point out that, even without an exemption of this type, the regulator already has the possibility to choose specific rules for specific pieces of infrastructure, both existing or new. Therefore, there is considerable scope for flexibility even without using the possible exemption.

For example regulators or Member States could, without any exemption being necessary, decide to give incentives to develop specific types of investment. This could, for example, be achieved by setting an allowed rate of return above the amount normally allowed for the main network. Regulators may also give long term commitments to a certain tariff structure or tariff methodology. This would be permitted provided that the regulatory framework fulfilled the requirement of the regulator to "approve a tariff methodology in advance", as set out in the Directives and also, if relevant, the requirement in the Regulation to "take into account" revenue collected as a result of congestion allocation procedures in the setting of charges for the overall use of the network. Similar commitments might also be made in relation to capacity allocation.

In this event, any decisions relating to the methodology for tariff setting or capacity allocation to be used for specific interconnectors, or other infrastructure, should be published and comply with the Directives and Regulation.

Different Types of Exemption

There is a range of possible exemptions which could apply. The main examples of which are as follows:

- Full exemption from Articles 20, 23(2), (3) and (4) of the electricity Directive [gas 18-20 and 25(2), (3) and (4)] with the effect that the infrastructure in question would not have to allow third party access <u>at all</u>. This would mean, for example, that project developers could retain all or part of the available capacity for themselves for the duration of the exemption: a so-called "own use" piece of infrastructure. They would have no obligation to publish tariffs or to negotiate in good faith. Nor, in the absence of any explicit conditions associated with the exemption, would there be any dispute settlement process or ex-post intervention possibilities. However, general competition law would continue to apply.

- a partial exemption from Articles 20, 23(2), (3) and (4) of the electricity Directive [gas 18-20 and 25(2), (3) and (4)] could also be envisaged with the effect that third party access would be offered but not necessarily on the basis of published tariffs. In this case the market potential users might be invited to commit to taking a certain amount of capacity in advance of construction through a so-called "open season". Alternatively, capacity might be offered after construction on the basis of an auction or individual negotiation. The regulator would approve the method used for offering the capacity but, in the absence of any explicit conditions associated with the exemption, there would be no dispute settlement process or ex-post intervention possibilities on the basis of Directives and the Regulation for the duration of the exemption. However, as with the first case, general competition law would continue to apply.

- Finally, for electricity, the infrastructure in question might merely be exempt from Article 6(6) of the regulation that deals with the use of congestion management revenues. Under such an exemption the infrastructure in question would be obliged to

comply with the congestion management guidelines agreed under the Regulation. There would therefore be approval of the methodology by the regulator and Article 23(2) would apply. However, the developer would not be obliged to use the revenues from congestion management methodologies for the purposes set out in Article 6(6) of the Regulation. The regulator's right to intervene ex-post, as set out in 23(4), would therefore also be constrained.

It must be recalled that any exemption awarded does not need to cover all the possible items identified in the Directives and Regulation. Exemptions may be granted independently from each of the Articles mentioned. There is no obligation on regulators\Member States to grant an exemption from all the items mentioned in this context. Likewise new investments may be covered by partial exemptions or conceivably be covered by two types of exemption. For example it might be 30% "own use" and fully exempt with the other 70% exempt from Article 23 with restricted TPA arrangements.

Criteria for awarding an exemption

The Gas Directive and the Regulation clearly state that exemptions will be considered on a case by case basis. However, it is clear from reading the criteria that certain types of projects are very unlikely to be eligible for such an exemption. The individual criteria are as follows:

(a) *the investment must enhance competition in electricity (gas) supply and enhance security of supply (gas only);*

(b) *the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted;*

(c) *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 interconnector will be built;*

(d) *charges are levied on users of that infrastructure;*

(e) *[only for electricity] since the partial market opening referred to in Article 19 of Directive 96/92/EC, no part of the capital or operating costs of the interconnector has been recovered from any component of charges made for the use of transmission or distribution systems linked by the interconnector;*

(f) *the exemption is not to the detriment of competition or the effective functioning of the internal electricity (gas) market, or the efficient functioning of the regulated system to which the infrastructure is connected.*

Some observations on these criteria are given below which, in particular give some simple examples of where it is considered that an exemption would not be appropriate. **This should not be taken to mean that an exemption would automatically be approved in the absence of such circumstances.**

- With regard to the requirement (a) that *the investment must enhance competition in electricity (gas) supply,* it is difficult to conceive of a case where an exemption could be granted to a new piece of infrastructure that was wholly or partly owned,

controlled or likely to have a significant amount of its capacity allocated to a dominant player in one of the markets affected. Of course if the project is conducted by an incumbent from another Member State, this causes fewer concerns.

- For Requirement (b), it is again hard to conceive of a justification for an exemption for a new investment for which the cost could be remunerated through general transmission tariffs with minimal impact on consumers. This refers back to the question of what constitutes a "major" project. Another factor to take into account is the likelihood of the interconnector in question enjoying an unchallenged dominant position in relation to the service it offers to participants in the markets, whether this be cross border transmission, LNG services or storage). The possibilities of competing investment projects is a determinant of this as well as the market conditions in the interconnected Member States. A greater likelihood of dominance, all other things being equal, lowers the riskiness of the investment, and makes an exemption less justifiable. The likelihood that a dominant position may arise is also relevant when the effect on competition is assessed in the context of condition (f) below. Typically, overland AC interconnector projects fall into both these categories.

- In addition, for Requirement (b) the principle of proportionality plays a decisive role, i.e. the requested exemption must be correspond to the level of risk. It must be demonstrated that without the exemption for the requested time and scope the infrastructure project would not go ahead. Important elements to be assessed are, among others, the expected costs of the projects as well as the revenues over time, the expected return on investment, the foreseen amortisation period and cost of capital assumptions. Infrastructure projects, which are at least partially financed by grant support from the Member State(s) concerned or the European Community would not normally qualify for an exemption to the extent that the project was publicly funded.[4]

- The conditions (c) and (d) relating to the legal separation of the infrastructure concerned and those relating to charges make it clear that the portion of the interconnector that is exempt from price regulation should not have any of its costs underwritten through regulated transmission charges. Both of these criteria aim at ensuring sufficient ring-fencing of infrastructure activities from network activities of major TSOs. The condition (d) requiring that users of the infrastructure should be subject to explicit charges again makes it difficult to conceive of exemptions for AC interconnectors which are subject to unattributable loop flows.

- Condition (e) - electricity only - effectively rules out any exemption of this type being applied to existing interconnectors. However as already noted, such interconnectors need not necessarily be treated as part of the general network and may have a specific regulatory methodology applied to them.

- Condition (f) has similarities with the first condition with the objective of defending a competitive market. However in this case it is noted that the exemption itself *should not be to the detriment of the competitive functioning of the market*. This is rather more difficult to evaluate. A lot will depend on the competitive status of the initial competitive position in the Member State concerned. For example in a market with significant concentration, the exemption should not imply a restriction on the

[4] Funding for preparatory studies, for example from TENs would not be considered funding for the project in this sense. Only funding for the actual construction costs would be considered to reduce the scope for an exemption.

possibility of entry of any type. This point would be particularly pertinent for an exemption from Article 20 [18-20] (all third party access).

- Condition (f) also implies that for any "exempt infrastructure" the operator would have to operate the infrastructure in a transparent manner and publish certain data on the operation of the interconnector or other infrastructure concerned. In addition, an exempt piece of infrastructure may be expected to provide incentives to ensure that unused capacity is not hoarded and, where practical, use-it-or-lose-it mechanisms would still be expected to apply. Similarly, it would be easier to demonstrate that such infrastructure did not create competitive concerns where the developer in question is able to demonstrate that it had offered access to third parties in designing the infrastructure in question, for example through an "open season" process.

Supporting information to be provided

Some discussion of the information to support such an exemption is contained in the Directive and Regulation. In particular the regulatory authority awarding the exemption should provide details of:

i. *the detailed reasons on the basis of which the regulatory authority, or Member State, granted the exemption, including the financial information justifying the need for the exemption;*

ii. *the analysis undertaken of the effect on competition and the effective functioning of the internal electricity market resulting from the grant of the exemption;*

iii. *the reasons for the time period and the share of the total capacity of the interconnector in question for which the exemption is granted;*

iv. *the result of the consultation with the Member States or regulatory authorities concerned; and, for gas,*

v. *the contribution of the infrastructure to the diversification of gas supply.*

The applicant for the exemption bears the burden of the proof to show that the necessary conditions to obtain it are fulfilled. Thus, any decision to award an exemption should, at a general level, clearly explain why a regulatory framework consistent with the Directive would not allow the construction of the asset in question. In particular the supporting information should demonstrate the particular aspects of the Directives and Regulation are problematic for the project sponsors and why no other means of dealing with this issue within the confines of the normal regulatory structure can be envisaged. In this context, the regulator supporting the exemption should provide relevant information on the reasons why it considers that project should not be underwritten through regulated transmission tariffs.

The project sponsors should give an exhaustive demonstration of the various risks associated with the project and a quantitative analysis of the risk-return profile for the project sponsors under different exemption regimes, including the possibility of providing a proportion of the infrastructure concerned on a normal regulated TPA basis. The appropriate financial information, referred to in point (i) above is relevant for evaluating the riskiness of the project. The information provided to the authorities must be identical to the information used for the internal making decision process of the project developers. If the project is financed by a third party (e.g a bank) all relevant information on the risk assessment (see above) provided to this party also needs to be

made available to the authority. The question of risk is also relevant to the time period for which the exemption is sought. As a guideline it is considered that the exemption should not be significantly longer than the period during which the project is expected to "break even".

A comprehensive explanation should be provided why an exemption would not be detrimental to competition in the relevant market concerned whether this is transmission, LNG or storage. In particular the scope for entry into the markets concerned should be demonstrated. Results of open season processes should also be provided.

The application for exemption should, for gas, provide a comparative and quantitative analysis of the security of supply position with and without the piece of infrastructure in question and identify the likely outcome if the project did not proceed, including the likely alternatives to the investment.

Interaction with Competition Policy

Every assessment of the competition effects of a major infrastructure investment will normally comprise of an analysis of the relevant infrastructure and energy supply markets. Owners of infrastructure such as interconnectors or LNG terminals may have a dominant position in the market for the particular service being offered or the downstream market, but may not have a similar market position on the energy supply market. In any case, this means that, even when an exemption has been awarded, the company concerned will be subject to of the EC competition rules, including Article 82 of the EC Treaty, presenting any abuse of this position (and any associated national competition law). An exemption from the Directives and Regulation does not give an exemption of any type from competition law and the possibility of intervention from competition authorities, including the Commission, will always exist.

The possibility for notification of certain practices to DG Competition for prior approval will cease as from May 2004. However this is without prejudice to the ability of the Commission to issue informal guidance to individual undertakings or to find the inapplicability of Article 81 of the EC Treaty on the basis of Article 10 of the Regulation 1/2003. In practice DG Competition will also be closely involved in any Commission decision to accept an exemption from the rules of the Electricity and Gas Directives and the Regulation.