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Date: 20 May 2008

Dear Colleague

### **BBL Gas Interconnector Expansion**

The Balgzand-Bacton Line (BBL) interconnector is a pipeline which conveys gas from the Netherlands to the United Kingdom (UK). BBL Company (hereafter referred to as BBL), which operates this pipeline, is proposing to expand the capacity of the interconnector through the installation of an additional compressor. It has obtained regulatory approval for its proposed tariff arrangements from the Dutch regulatory authorities. In order to comply with its UK Interconnector Licence, it also needs to obtain approval of its tariff arrangements from the Authority<sup>1</sup>.

BBL has asked that rather than Ofgem assessing the tariff directly, whether Ofgem would be willing to grant approval of the tariff under paragraph 13 of Standard Licence Condition (SLC) 10 of BBL's Interconnector Licence. This allows for Ofgem to utilise the approval granted by other regulatory authorities in coming to its decision on compliance of the tariff with the licence requirements. This consultation details Ofgem's proposal to grant approval of BBL's proposed tariff by this method.

### **The Interconnector Licensing Regime**

The gas interconnector licence regime was introduced into the UK following implementation of Directive 2003/55/EC<sup>2</sup> (the "Directive") and the UK Energy Act 2004. These have since been supplemented by Regulation 1775/2005<sup>3</sup> (the "Regulation").

#### *Directive 2003/55/EC*

The Directive regulated Third Party Access (TPA) for, amongst other things, gas interconnectors.

Article 18 of the Directive required TPA to certain gas facilities based on tariffs applicable to all customers without discrimination, including interconnectors, based on:

- Approval of the tariffs or charging methodologies by the regulator, and
- Publication of tariffs or charging methodologies

prior to their entry into force.

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<sup>1</sup> The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.

<sup>2</sup> Directive 2003/55/EC of the European Parliament and of the Council Concerning common rules for the Internal Market in Natural Gas and Repealing Directive 98/30/EC

<sup>3</sup> Regulation 1775/2005 of the European Parliament and of the Council of 28 September 2005 on conditions for access to the natural gas transmission networks

The Directive did not prevent the conclusion of long-term contracts as long as they complied with European Community competition rules.

Article 25 of the Directive required the creation of independent regulators responsible for ensuring non-discrimination, effective competition and the efficient functioning of the gas market. This gave certain responsibilities to regulators including the fixing or approval of charging methodologies for connection and access to national gas networks.

However, Article 22 of the Directive allowed for major new gas infrastructures, significant increases of capacity in existing infrastructure and modifications to existing infrastructures which enable the development of new sources of gas supply to be exempt from certain aspects of the Directive including the TPA arrangements, set out in Article 18, and regulatory approval of the charging methodologies, as set out in Article 25. These exemptions were subject to certain conditions, including:

- The investment must enhance competition in gas supply and enhance security of supply
- The level of risk attached to the investment is such that the investment would not take place without the exemption
- The infrastructure must be owned by an entity which is legally separate from the system operators in whose systems the infrastructure is to be built
- Charges are levied on the users of the infrastructure
- The exemption is not detrimental to competition or effective functioning of the internal gas market or the efficient functioning of the regulated system to which the infrastructure is connected

Furthermore, the exemptions could cover all or parts of the new infrastructure, the existing infrastructure with significantly increased capacity or the modification of existing infrastructure.

The decisions on exemptions are to be done on a case-by-case basis based on certain criteria and may provide conditions for the exemption regarding the:

- Duration of the exemption, and
- Non-discriminatory access to the interconnector

When deciding on these conditions the duration of contracts, additional capacity to be built or modified, the time horizon of the project and national circumstances will be taken into account.

For interconnectors an exemption decision shall be taken only after consulting regulators in other relevant member states. Such exemption decisions have to be notified to the European Commission. The European Commission may then request the regulator to amend or withdraw the exemption.

#### *Energy Act 2004*

The Energy Act 2004 incorporated aspects of the Directive into UK law. Specifically the Energy Act 2004 gave the Authority powers to issue gas interconnector licences. The licences for existing gas interconnectors would be issued by the Department of Trade and Industry<sup>4</sup> (DTI) following consultation on the standard licence conditions. The Energy Act 2004 also allowed for the suspension of certain licence conditions.

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<sup>4</sup> The DTI has since been disbanded with some of its responsibilities now undertaken by the Department for Business Enterprise and Regulatory Reform.

### *DTi consultation*

The DTi conducted a number of consultations on the standard gas (and electricity<sup>5</sup>) interconnector licence conditions between July 2004 and March 2005. The standard licence conditions were designated by the DTi on 18 March 2005.

As a result of the consultation the idea of the Authority approving a charging methodology that had already been approved by another regulatory body was incorporated into the standard licence conditions.

### *Gas Interconnector Standard Licence Conditions*

The requirements regarding interconnector licences under the Energy Act 2004 came into effect on 14 August 2006. However, gas interconnector licences were issued prior to this date so that the existing interconnector operators were not in breach of the Act. Ofgem issued the gas interconnector licence to BBL on 8 April 2005.

The gas interconnector licence has a set of standard licence conditions. Part II Sections A to C of these standard licence conditions deal with a number of general issues including definitions, licence fees, bilateral agreements, information provision to the Authority and National Grid Gas NTS (NGG NTS), separation of accounts and revenues. Part II Section D encompasses conditions 10 to 14 which deal with the issue of TPA. The requirements of standard licence conditions 10 to 12 are described below.

SLC 10 requires the interconnector operator to enter into contracts based on the most recently approved charging methodology.

For the initial approval of the charging methodology the interconnector operator has to prepare and submit its charging methodology to the Authority for approval following a consultation process of at least 28 days. The objectives of the methodology are for it to be:

- Objective
- Transparent, and
- Non-discriminatory

The interconnector operator is then required to publish the charging methodology and the charges resulting from application of the methodology 28 days prior to it coming into effect.

The licensee is required to review the charging methodology at least once a year, and more frequently if requested by the Authority to do so. These reviews are to be done through consultation and then re-submitting it to the Authority, which has then 28 days<sup>6</sup> in which to decide whether or not to veto the proposed modification.

SLC 10 allows for the Authority to exempt the interconnector operator from having an approved charging methodology in place and publishing it on its website. This is possible by two means:

1. 'approval by approval' – where a charging methodology has been established or approved by a regulator other than Ofgem and it meets the methodology objectives. In this case the Authority may issue a notice that the establishment or approval by the other regulator meets the requirements of the licence and such notice constitutes approval of the charging methodology. The Authority may specify an expiry date and also has the power to withdraw this exemption notice. Where such a

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<sup>5</sup> The Energy Act also introduced a similar licence regime for electricity interconnectors, as a result of Directive 2003/54/EC of the European Parliament and of the Council concerning common rules for the internal market in electricity and repealing Directive 96/92/EC. The gas and electricity interconnector licence conditions share similar features.

<sup>6</sup> In the event of an impact assessment being conducted the Authority has 90 days.

notice has been issued, and the tariff or charging methodology is to be modified the interconnector operator is still required to consult on the changes.

2. 'existing approved methodologies' – where a contract for access to the interconnector had been entered into before 1 July 2004, and had been entered into on the basis of a charging methodology that had been approved by the Authority or the European Commission the Authority, subject to certain conditions, can issue an exemption notice. This may be given unconditionally or on conditions as the Authority sees appropriate. In this case the interconnector operator has to inform the Authority of any changes to such contracts.

SLC 11 requires the interconnector operator to enter into an agreement with any party applying for access to the interconnector and that the non-price terms and conditions of which are transparent, objective and non-discriminatory.

However, the interconnector operator does not have to enter into such an agreement where there is a lack of capacity to its interconnector. In which case, the interconnector operator must inform the applicant and the Authority of the economic and technical reasons for declining access within 28 days. In this situation if the applicant requests relevant information on the necessary measures to reinforce the network to provide the capacity it applied for, then the licensee will oblige (and may charge a reasonable fee for doing so). However, the licensee may seek consent from the Authority not provide particular information it considers confidential.

SLC 12 allows for either or both SLC 10 and 11 to be 'switched off'. However, this is only possible for either a new interconnector<sup>7</sup> or for the part that represents a significant increase in capacity of an existing interconnector or modification to an existing interconnector which enables the development of new sources of gas supply. The exemption may be for an indefinite or finite period and unconditional or subject to conditions the Authority considers appropriate. The exemption order may be revoked in accordance with its provisions.

The requirements for an exemption are as set out in Article 22 of the Directive, as set out above.

#### *Regulation 1775/2005*

The aim the Regulation is to set non-discriminatory rules for access conditions to natural gas transmission systems. The objectives of the Regulation include setting harmonised principles for tariffs, charging methodologies and access to the networks and the establishment of TPA services.

The Regulation required that the tariffs or charging methodologies approved by the regulators pursuant to Directive 2003/55/EC:

- are transparent
- take into account the need for system integrity and its improvement
- reflect actual costs incurred, insofar as such costs correspond to those of an efficient and structurally comparable network operator, whilst including appropriate return on investment and where appropriate take account of benchmarking
- should be applied in a non-discriminatory manner
- should facilitate efficient gas trade and competition while at the same time avoiding cross-subsidies
- provide incentives for investment and maintain or creating interoperability for transmission networks

The Regulation required that TPA services, amongst other things:

- are offered on a non-discriminatory basis to all network users

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<sup>7</sup> A new interconnector is defined as an interconnector not completed by 3 August 2003.

- provide both firm and interruptible TPA services, with the price of interruptible capacity reflecting the probability of interruption
- offer both long and short-term services

## **BBL Interconnector History and Proposed Expansion**

BBL was established on 9 July 2004 to design, construct and operate an interconnector for the transportation of gas from Balgzand, in the Netherlands, to Bacton, in the UK.

The BBL interconnector provides services to physically flow gas from the Netherlands to the UK. Currently, it is not designed to physically flow gas from the UK to the Netherlands.

The initial, and current, capacity for gas flow from the Netherlands to the UK is 1.75 million cubic metres per hour (ie, 15 bcm/year). Transportation of gas to the UK, via the BBL interconnector, started on 1 December 2006.

### *BBL exemptions*

On 8 April 2005<sup>8</sup> the BBL interconnector was given an exemption from SLCs 10 and 11, pursuant to SLC 12, until 2 December 2022 with respect to any forward physical flow<sup>9</sup> and non-physical reverse flow<sup>10</sup> of the BBL interconnector.

In accordance with the Directive the European Commission requested that the Authority amend the exemption granted to BBL. The European Commission requested that the exemption only be given in respect of the duration and capacity specifically covered by the initial contracts signed by BBL and that both physical and non-physical reverse flow nominations be excluded from the exemption.

Therefore, the exemption was amended on 9 August 2005<sup>11</sup> to give the BBL interconnector an exemption from SLCs 10 and 11 pursuant to SLC 12 until:

- 2 December 2016 with respect to approximately 1.15 mcm/hour of capacity for the physical forward flow of gas from the Netherlands to the UK
- 2 December 2022 with respect to approximately 0.6 mcm/hour of capacity for the physical forward flow of gas from the Netherlands to the UK

This exempted BBL from publishing an approved charging methodology and allowing TPA to its interconnector, subject to the capacity and time limits given.

### *History of proposed expansion*

In May 2007 BBL began investigating market interest for increased capacity of its interconnector through an open season. It presented two options for increased interconnector capacity between the Netherlands and the UK, these were:

1. Construction of a fourth compressor, with extra capacity of 3 bcm/year; or
2. Construction of a fourth compressor + new pipeline, with extra capacity of 8 bcm/year

Eighteen parties expressed their interest in the open season which resulted in four shippers signing a booking agreement for contracting firm forward flow capacity. The commitments by these shippers resulted in a positive business case for the expansion project. Not all capacity offered in the Open Season has been contracted, so there is still capacity on offer (subject to final project go-ahead).

<sup>8</sup> See [http://epr.ofgem.gov.uk/document\\_fetch.php?documentid=11562](http://epr.ofgem.gov.uk/document_fetch.php?documentid=11562)

<sup>9</sup> Physical Forward flow means the physical flow of gas in the direction from the Netherlands to the UK.

<sup>10</sup> Non-physical reverse flow means a reduction in the physical forward flow in substitution for a physical reverse flow.

<sup>11</sup> See [http://epr.ofgem.gov.uk/document\\_fetch.php?documentid=11561](http://epr.ofgem.gov.uk/document_fetch.php?documentid=11561)

The extra capacity will be made available by adding a 4th compressor at the compressor station in The Netherlands, equating to around 3 bcm/year of extra capacity, to be available to the market in 2010-12.

### **Regulatory considerations**

The first meeting between Ofgem and BBL to specifically deal with the issue of the interconnector capacity expansion was in May 2007. In that meeting, BBL outlined its plans for the Open Season and questioned whether it would be possible to extend the exemption applying to the existing capacity to the projected new capacity. We confirmed that the existing exemption would not extend to this capacity, and that any application for a new exemption which might apply to significant increases in capacity would be based on the tests as set out in the Directive.

Consequently, BBL decided not to pursue the route of applying for an exemption, both on the grounds that it considered that it would not be fully able to demonstrate compliance with the criteria and also that the typical timescale involved in applying for an exemption would be too time consuming. Accordingly, BBL need to demonstrate compliance with the requirements of SLC 10 ("Charging methodology to apply to third party access to the licensee's interconnector") and SLC 11 ("Requirement to offer terms for access to the licensee's interconnector") for the projected new capacity.

In our following meeting, BBL proposed using an indirect approval method as a means of demonstrating compliance with SLC 10 of its interconnector Licence. Paragraph 13 of SLC 10 provides that Ofgem may, in certain circumstances, issue a notice to the effect that approval of the tariff or charging methodology by a regulatory authority other than Ofgem meets the requirements of SLC 10. Those circumstances are that:

- The inter-connector either forms or does not form part of an integrated transmission system; and
- The tariffs and/or the tariff or charging methodology that applies to access to the inter-connector have been established or approved by a regulatory authority; and
- Those tariffs or the methodology meet the relevant charging objectives.

This means of compliance with the requirements of SLC 10 is referred to as "approval by approval" in the remainder of this letter. Ofgem agreed to consider this means of approval, but noted that:

- Such an approval would have to be based on a positive affirmation of the tariffs/charging methodology by another regulatory authority, ie we could not approve the tariffs based on the other regulatory authority granting an exemption; and
- The approval by the regulatory authority would have to include substantive detail on the basis for granting approval, such that Ofgem could use this to assess whether the tariffs meet the relevant charging objectives as specified in the UK Licence

In addition, we stated that since this would be the first time that Ofgem had considered this procedure as a means of approving tariffs, we would be likely to consult on it, albeit for a shorter time than usual due to the commercial urgency of the project timing.

### **Approval by the Dutch Regulatory Authorities**

During the early part of 2008, BBL has been in discussions with Ofgem and the Dutch regulatory authorities to explore how this approval by approval process could work. After consideration of the issues, it was decided that the Dutch Ministry for Economic Affairs (MEA) was the regulatory authority that should decide on the approval or otherwise of the proposed tariffs for the expansion capacity on the BBL interconnector. The MEA has conducted its assessment of the tariffs and decided that:

- The tariffs were being applied in a non-discriminatory manner, in that the tariffs being offered to parties contracting for the proposed expansion capacity were the same as those which applied to the existing exempted capacity;
- The tariffs were objective in that they consist of a fixed fee for capacity, an adjustment formula indexed to inflation and a variable fee to cover compressor running costs; and
- The potential increase in overall project profit as a result of the investment in an additional compressor is not disproportionate

An English translation of the MEA's decision letter is attached as an appendix. Due to the confidential nature of some of the commercial data, certain figures have been removed from the letter.

Accordingly, it is now up to Ofgem to decide on whether to grant approval by approval of the BBL tariffs.

### **Ofgem's considerations**

Paragraph 13 of SLC 10 of BBL's interconnector licence states that the Authority may issue a notice that the approval of tariffs/charging methodology by another regulatory authority constitutes the approval of a charging methodology for the purposes of SLC 10, so long as the tariffs/charging methodology meet the relevant charging methodology objectives. Paragraph 4 of SLC 10 defines the relevant charging methodology objectives as "The charges and the application of the underlying charging methodology shall be objective, transparent and non-discriminatory". Therefore, Ofgem would need to be satisfied that the BBL tariffs meet these criteria before it could recommend approval of the tariffs by the Authority.

#### Is the tariff objective?

The proposed tariff is the same as the existing tariff, having a fixed capacity rate (which is indexed for inflation) and a variable fee to recover compressor running costs. Therefore, the capacity rate has to recover the initial costs of the investment in the compressor, maintenance costs and appropriate financing costs. The financing costs have to incorporate a suitable premium for the risk that a significant proportion of the expansion capacity might not be sold; whereas the open season process has given BBL some certainty as to the minimum capacities that will be taken up, there is still a substantive portion of the expansion capacity still available for sale.

We consider that in this instance, the proposed tariff is a reasonable mechanism to recover its costs and provides an acceptable level of risk and reward for BBL. On the basis of the available evidence to date, Ofgem's view is that the tariff can be considered to be objective.

#### Is the tariff transparent?

During the open season process, BBL made copies of its transmission services agreement (which contains the tariff structure for the expansion capacity) available to all parties who expressed an interest in obtaining capacity, though only if those parties signed a confidentiality agreement. In our subsequent discussions on the approval process, we highlighted the issue of tariff transparency to BBL and as a result it has posted its transmission services agreement on its website<sup>12</sup>. Accordingly, we consider that the tariff structure is now transparent.

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<sup>12</sup> [www.bblcompany.com](http://www.bblcompany.com)

Is the tariff applied in a non-discriminatory manner?

The transmission services agreement is a standard document which applies to both existing and prospective purchasers of capacity on the BBL interconnector, so it would appear that the tariff is being applied in a uniform and non-discriminatory manner.

On the basis of its considerations at this point, Ofgem's view is that the proposed tariff meets the relevant charging methodology objectives and so it is minded to recommend that the Authority grants an approval by approval of the BBL expansion capacity tariff. Whereas such an approval would constitute compliance with the requirements of SLC 10, we would remind the licensee that they will also need to demonstrate compliance with the requirements of SLC 11 for the proposed expansion capacity. Ofgem reserves the right to examine such aspects at a later date.

**Next steps**

Ofgem would be interested in receiving comments from interested parties as to the process involved in the approval by approval route for tariffs/charging methodologies and/or any comments on Ofgem's minded to view to grant approval of the BBL tariff. In light of the commercial urgency of this project, we are asking for responses by **Wednesday 4 June**. Any respondent who does not wish their response to be made public should clearly mark the response as not for publication.

If you have any queries on this letter, please contact Paul O'Donovan on 020 7901 7414 in the first instance.

Yours faithfully,



**Steve Smith**  
**Managing Director, Networks**

# Appendix Minute

Auteur  
*Kenessey de Kenese / Van den Berghe*

Toestelnummer  
6689

Classificatienummer

Datum  
14-4-2008

Uiterste verzenddatum

Verzendwijze

Aan  
**CONFIDENTIAL**

Informatiekopie aan

Medeafoening van ons kenmerk

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ET/EM / 8046187

Onderwerp

Tariffs expansion BBL pipeline

Dear Mr. Faber,

In my letter of March 19 (Ref: ET/EM/8032279), I provided my view on the regulatory framework for the proposed expansion of the BBL pipeline with a fourth compressor.

Through that letter I have decided that the regulatory regime mentioned in the decision of 10 August 2005 (reference E/EM/5050373) which is effective after the expiration of the first initial contract on the BBL pipeline, is similarly applicable to the extra capacity that will become available by expansion of the BBL pipeline with the fourth compressor.

My considerations hither were as follows. The existing infrastructure and capacity of the BBL pipeline and the construction of the fourth compressor are interwoven. By the construction of the fourth compressor the maximum technical capacity of the pipeline is reached. At the bottom line, a certain amount of capacity that was already implied in the already built BBL pipeline is rendered usable by means of this compressor. Furthermore, in the case in question a deviant regulatory framework for the fourth compressor would bring large risks for the economic viability of the BBL pipeline in its entirety. The aim of the original exemption would be undermined thereby. Finally, the non-discriminatory application of the regulatory framework for the entire technical capacity of the BBL pipeline assures that parties can compete to similar extent for the transport capacity between Balgzand and Bacton.

Bezoekadres

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Paraaf en Datum

Behandeld door

**Kenessey de Kenese / Van  
den Berghe**

This decision is in line with the view of the relevant services of the European Commission as expressed by their letter of March 5. Furthermore, the regulatory regime as decided by the decision of 10 August 2005 (reference E/EM/5050373), which is effective after the expiration of the first initial contract on the BBL pipeline, has been brought to the attention of the European Commission. The European Commission did not see a ground for any further remarks.

The regulatory framework means specifically that:

- a) for the period 2010-2022 BBL Company has to develop for the extra capacity of 0.37 mln. m<sup>3</sup>/h a market oriented, non-discriminatory and transparent mechanism for the allocation of the available capacity,
- b) BBL Company is allowed to take into account the tariffs and conditions that apply to the two longest-running initial contracts of the original BBL pipeline for its tariffs,
- c) DTe, in dialogue with Ofgem, assesses ahead whether the mechanism for allocation complies with the demands for transparency, market orientation and non-discrimination,
- d) the mechanism, the tariffs and conditions have to be published by BBL Company ahead.

Next to my decision expressed in my letter of 19 March 2008 (Ref: ET/EM/8032279), I consider it my duty, as governing body that has granted the original exemption, to provide further explanation on the exemption, among others concerning the first amendment which states that BBL Company is allowed to take into account the tariffs and conditions that are used in the two longest running initial contracts for the period after the expiration of the first initial contract on 2 December 2016 until 2 December 2022. As this framework is also relevant to the tariffs and conditions regarding the capacity that will become available with the construction and start of operational activity of the fourth compressor, I consider such further explanation increasingly necessary.

The non-discriminatory application of the tariff methodology for all capacity of the pipeline is necessary to comply with the requirement of non-discriminatory access to infrastructure as mentioned in Decision 1775/2005. By application of an identical tariff methodology for both the period from 2 December 2016 until 2 December 2022 as well as for the period from the start of availability of capacity due to the fourth compressor until 2 December 2022, market parties can compete similarly for transport capacity between Balgzand and Bacton and non-discriminatory tariffs will be charged.

I have compared the tariff proposals of BBL Company for the capacity resulting from the expansion with the fourth compressor with the tariff methodology that applies to the (presently operational) exempted contracts. Specifically, the tariffs

proposed follow the methodology applied in the three initial contracts: a fixed fee for capacity (in m<sup>3</sup>/hour), an adjustment formula for the duration of the contract, indexation to inflation, and a variable fee to cover the cost for electricity to drive the compressors. The tariff methodology and thereby the resulting tariffs for the additional capacity comply to the requirements I have outlined above and which comply with the requirements of the regulatory regime as mentioned in the decision of 10 August 2005 (reference E/EM/5050373) which is effective after the expiration of the first initial contract. I concluded that the tariff proposals comply with the framework put forward by the first amendment of which the regime is similarly applicable to the additional capacity of the fourth compressor.

Decision 1775/2005 requires that tariffs have a relation with costs. Therefore, I have performed a study into the relationship between on the one hand the tariffs, resulting from the existing tariff methodology as applied to the existing contracts, the contracts that become operational with expansion with a fourth compressor, and the possibly additional contracts on the BBL pipeline, and on the other hand the costs including a proportional profit. I deemed a renewed study into this relationship necessary, as the costs of expansion amount to approximately 5% of the costs of the original project, while the expansion increases the transport capacity by approximately 20%. Specifically, the expectation of the profit shows the following. In the investigation in the framework of the original exemption, a profit of 10% was applied and considered proportional. This profit would be reached if until 2026 10% of the capacity beyond the initial contracts would be sold. Without this extra sale, the profit based on the three initial contracts would amount to 10%. For the BBL pipeline including the booking agreements signed for the expansion with the fourth compressor, a profit of 10% is foreseen, excluding the sale of remaining capacity. I do not consider this increase by 0.4 percentage points as disproportional, amongst others because the exemption ends in 2022 and the pipeline will be placed from that moment onwards under a completely regulated regime.

The study resulted in the conclusion that it is highly unlikely that the proposed expansion results in a disproportional profit on the total investment, consisting of both the original project as well as the proposed expansion.

The Minister of Economic Affairs,  
On her behalf,

drs. M.M. Frequin  
Director General for Energy and Telecommunication