Willem Faber
BBL Company
P.O. Box 225
9700 AE Groningen
The Netherlands

Promoting choice and value for all gas and electricity customers

Direct Dial: 020 7901 7009
Email: stuart.cook@ofgem.gov.uk

Date: 13 May 2010

Dear Mr Faber

Approval of BBL Company's proposed charging methodology for a non-physical interruptible reverse flow product

The Balgzand-Bacton Line (BBL) interconnector conveys gas from the Netherlands to the Great Britain (GB). BBL Company (hereafter referred to as BBL), which operates this interconnector, provides physical flow products (both firm and interruptible) in the direction from the Netherlands to GB but does not currently provide any flow products from the GB to the Netherlands.

Under the terms set by the EU Commission in relation to the exemption from certain requirements for third party access to the interconnector, BBL has an obligation to introduce interruptible reverse flow services from GB to the Netherlands (hereafter referred to as "reverse flow"). However, the Commission noted that there is no actual physical capacity to facilitate a reverse flow and so BBL will provide a non-physical reverse flow product. This is essentially a product which nets off contractual flows in the reverse direction against the physical forward flows. As it is dependent on there being a forward physical flow to net off against, the product is by its nature interruptible.

In order to comply with its GB Interconnector Licence[1], BBL needs to obtain approval of its tariff arrangements for this product from the Authority[2] either before BBL enters into an agreement or before the tariffs under the agreement fall due. The Authority has previously rejected a charging methodology proposal submitted by BBL for this product[3], and subsequently, BBL has conducted a number of industry consultations with a view to determining an appropriate product charging methodology. On 26 April 2010, BBL submitted a report to the Authority seeking approval of its proposed non-physical interruptible reverse flow product charging methodology. This letter sets out the Authority's decision to approve the proposed methodology and explains the reasons for the Authority's decision.

BBL non-physical interruptible reverse flow charging methodology

BBL conducted both an informal and a formal consultation[4] on the proposed charging methodology during 2010. The informal consultation sought feedback from shippers on the principle of auctioning the reverse flow product, and views on the services and products

[1] Specifically, the requirements of Standard Licence Condition (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) must be complied with
[2] The terms 'the Authority', 'Ofgem' and 'we' are used interchangeably in this document. Ofgem is the Office of the Gas and Electricity Markets Authority.
[3] "BBL Company reverse flow product charging methodology", Ofgem, 28 October 2008
[4] These can be found at www.bblcompany.com

that would be of interest to the market. BBL received six responses to this consultation. The subsequent formal consultation set out a proposed methodology, giving specific detail on the nature and frequency of the products to be auctioned, and on how BBL considered their costs should be recovered. BBL received seven responses to the formal consultation, three of which were received after the submission deadline. In light of these responses BBL has further amended its proposed methodology in respect of the size of capacity tranches and cost recovery.

The proposal submitted by BBL comprises the following key features:

- Capacity will be sold by single round pay-as-bid auctions, with a zero reserve price.
- The available reverse flow capacity for sale will equal the sold forward flow capacity at any particular time.
- Capacity will be sold as quarterly, monthly and daily blocks, in tranches of 30,000kWh/hour. Thirty-six such tranches will be reserved for each of the quarterly and monthly blocks; the remainder (which constitutes c.88% of the available capacity) will be sold on the day.
- In the event of interruption being necessary, the shorter period capacity blocks will be interrupted first, ie the interruption order will be daily capacity first, then monthly, then quarterly.
- Shippers will be required to pay a maximum annual subscription of €35,000 to participate in the auctions; this revenue will go towards the recovery of BBL's efficiently incurred auction costs (setup and ongoing running costs). Any over-recovery will be rebated amongst the participating shippers.
- BBL will publish capacity availability data on its website, in line with its current practice on forward flows.

Methodology assessment against GB Licence requirements

The interconnector licence requires charging methodologies to be objective, transparent and to be applied in a non-discriminatory manner[5].

Requirement to be objective

In accordance with the provisions of Article 3 of Regulation 1775/2005 we have previously given guidance to BBL that Ofgem generally considers that charging methodologies comply with the "objective" criterion if they are either market-based or cost-reflective. Whereas single round pay-as-bid auctions might not allow for the same level of price discovery as multiple round auctions, in the context of the proposed product, we are content at this time that such single round auctions can be considered to be market-based, so that it meets the "objective" test; however, we expect BBL to keep this aspect of the proposed methodology under review. We note that the proposed subscription fee is intended to cover set-up and running costs of the auctions. We are content that this aspect of the methodology can be considered to be cost-reflective. We comment further on this below.

Requirement to be transparent

The methodology presents a clear schedule of when the different products are to be auctioned and specifies how the product availability information is to be conveyed to the market. It also sets out a revenue target for recovery of administration and set-up costs, places a cap on individual shipper liability for the initial year of service provision and specifies how excess revenues recovered through shipper subscription fees are to be dealt with. Therefore, Ofgem considers that the proposed methodology meets the transparency criterion, both in terms of capacity allocation information and cost to parties wanting to utilise the service.

[5] Standard Licence Condition 10.3 of the Gas Interconnector Licence

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Requirement to be applied in a non-discriminatory manner

BBL proposes that all subscribing shippers can participate in the auctions and price will be the primary determinant of capacity allocation. The sole exception to this will be where the total of capacity bids for the same product at the same price level exceeds the available capacity; in this instance, it proposes that the capacity will be allocated preferentially to the earlier time-stamped bid, ie on a first come, first served (FCFS) basis. In principle, Ofgem does not favour the use of FCFS allocations, as this form of allocation is somewhat arbitrary in nature and may not reflect the value that users attach to the capacity; however, in this instance, we are minded to accept this as an initial means of determining allocations in the specific instance described because:

a. We expect this will be a rare occurrence.
b. BBL has claimed that its current systems are unable to allocate the capacity on a pro-rata basis in the event of identical bids being made for the same capacity product. It was considered that in view of the potential costs and time delays involved in rectifying this, it would be more appropriate to monitor the frequency of occurrence before deciding on the appropriate course of action.
c. We would expect BBL to keep this aspect of the proposed regime under review, and take appropriate action if required.

Accordingly, although we have concerns with respect of the use of FCFS to allocate oversubscribed capacity when bids are equally priced, the fact that price is the primary determinant of allocation and the likelihood of FCFS being used to allocate capacity is very low provides comfort that this should not be a significant problem. On this basis, we consider that the charging methodology can be considered non-discriminatory.

The Authority's Decision

Having considered the charging methodology submission by BBL, and the responses to its prior consultations on that methodology, the Authority has decided that the proposed methodology meets the requirements of SLC 10 of BBL's Gas Interconnector Licence. The methodology will now be subject to consideration by the Dutch regulatory authorities; in the event of it being granted the necessary approval by them, we would expect BBL to proceed with the commercial arrangements to implement the provision of these services as soon as possible.

Further considerations

Although we have approved the charging methodology as submitted to us, there are a number of related issues that merit further discussion in addition to the areas expressly identified above.

Product range

There were a wide range of views expressed by respondents with regards the types of products required. Some parties expressed interest in a daily "day-ahead" product, while other parties requested that the Quarterly product should be bookable for a period of up to two years in advance. BBL has indicated a commitment to implement a day-ahead product "as soon as reasonably practicable", and we welcome this. BBL expressed reservations on making the Quarterly product available over a longer time frame, as it was concerned shippers could hoard this capacity. Ofgem considers that it would be beneficial for shippers to have access to longer-term products, and expects BBL to keep the product range under review.

Proportion of capacity allocated to product types

Again, on this issue there were a wide range of views expressed by respondents, with some considering that the capacity should be preferentially offered to the long-term products, while others said market interest would be focussed on the short term product. The current proposal reserves approximately 6% of the maximum forward flow capacity for

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each of the Quarterly and monthly products, with the remainder being allocated for the daily product. BBL submitted a review of its forward physical flows during 2009, mapped against the price differential between the GB National Balancing Point (NBP) and the Dutch Title Transfer facility (TTF) when the TTF price was more than €1/MWh greater than the NBP price. This indicated that on about half of these occasions, the forward flow levels were less than 20% of the forward flow capability, and led BBL to conclude that the forward flows do react to the market conditions. On this basis, BBL concluded that to reserve larger quantities of capacity for the longer term auctions would significantly diminish the value of the short term product, as there would be a high probability of interruption on the days when there would be a significant demand.

It is clear that there has been a very mixed signal given by the market as to its requirements, and so BBL has taken a view of the appropriate proportions to be allocated to the products based on what it perceives to be an objective criterion. Whereas we have accepted this as reasonable at this point in time, we would note that the 2009 data is somewhat different from the analysis carried out by NERA and submitted to us by BBL last year, and in any event, past flows are not necessarily a good indicator of future behaviours. We would also be concerned if the outcome of this apportionment was to create an artificial scarcity of the longer term products, thereby inflating the associated auction bids. Therefore, we would expect BBL to keep this capacity allocation under review, such that next year's methodology submission has a more robust justification of the proportions of capacity allocated to each of the products.

Auction revenues

BBL has questioned the likely take-up of the reverse flow product by shippers, and considers that the revenues arising from the auctions will not be substantial. However, there has been a continued interest from market participants in the development of the reverse flow service, which might suggest that, absent barriers to entry, there should be sufficient interest in the product. However, due to this uncertainty, we have agreed with BBL to monitor the take-up of the service, and the revenues that arise from it. We will take such revenues into account when assessing the suitability of any subsequent proposed charging methodology going forward. We would also consider that if there is a strong revenue stream from the auctions, this may suggest that the provision of a physical reverse flow service should be further explored by BBL[6].

We note that BBL has entered into contracts with the original forward flow capacity holders with regards to revenues arising from sales of the reverse flow product. In our 2008 decision letter on the previous charging methodology submission[7], we clearly stated that such contractual arrangements are not taken into account when assessing the suitability of the methodology. However, if we considered that these contractual terms acted so as to obstruct the take-up of the reverse flow service, we may take action to challenge the suitability of these arrangements.

Subscription fee

Allied to the above point, we would wish to keep the use of a subscription fee under review. If the level and/or the structure of this fee are found to be significant inhibitors to the take up of the reverse flow service, we would expect BBL to give active consideration to whether the fee should be reviewed and potentially modified[8].

Set-up and operating costs

One respondent asked for regulatory oversight of the costs which make up the shipper subscription fee, to ensure that they represent an efficient level. BBL has provided some

[6] BBL's GB interconnector licence includes an obligation to make available maximum capacity of the interconnector
[7] See reference 3 previous
[8] BBL is required to submit a revised charging methodology for approval on an annual basis

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high-level estimates of these from its nominated service provider, on a commercially confidential basis. We have not subjected these cost estimates to detailed scrutiny, but reserve the right to review these costs once the systems are in place and operational, to ensure that only efficiently incurred costs are remunerated through the subscription fees.

Competition issues

A consultation response from another interconnector alleged that the proposed methodology did not recover the true costs of providing the service and therefore could be considered as a form of predatory pricing behaviour. Ofgem does not agree with this respondent.

As previously stated, BBL is providing these services to meet the conditions of the EU Commission ruling on its forward flow tariff exemption. The Commission considers these services are important to prevent a distortion of trade within the gas market. The Commission has proposed that the services should be provided through a market-based mechanism, and BBL's auction service complies with this requirement. Further, the proposed methodology incorporates details of the set-up and operating costs, and the levels of cost recovery required to meet these costs. We do not believe that the service proposal could be characterised as predation[9].

Entry/exit issues

BBL's proposal places the onus on shippers to ensure they secure the requisite amounts of entry and exit capacities on the GB and Dutch systems respectively. Some respondents noted the current industry moves to offer combined or bundled products where the entry and exit capacities are sold along with the capacity, and asked that BBL's proposal should ensure it is consistent with these developments. Ofgem notes these views, but since there are no firm rules mandating such products, we believe that this is an issue for consideration in future methodology submissions.

Another respondent questioned the need for entry and exit capacity bookings to be made, as take-up of the reverse flow product results in reduced physical flows. This respondent considered that the requirement to book capacity would significantly affect the commercial viability of the product, in part due to the comparatively high entry charges to the Dutch network (relative to the typical level of the arbitrage opportunity). Whereas this is somewhat outside the scope of the charging methodology, we note that the exit capacity on the GB side is to be offered as an auctionable product, which has a zero reserve price and is interruptible.

If you have any further questions on the issues raised in this letter, please feel free to contact Paul O'Donovan on +44 20 7901 7414 or at paul.odonovan@ofgem.gov.uk in the first instance.

Yours sincerely,

Stuart Cook
Senior Partner, Transmission and Governance
Duly authorised on behalf of the Gas and Electricity Markets Authority

[9] It is important to note that this decision letter relates to the proposed methodology for interruptible reverse flow. It is for BBL to ensure compliance with the Competition Act 1998 and EU competition law in its implementation of the proposed methodology. As a consequence, this decision does not limit or prejudice any findings which the Authority may make in relation to investigations under the Competition Act 1998 or EU competition law.

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