ofgem

Memo

Ofgem's[1] final decision and analysis on Interconnector (UK) Limited's ("I(UK)'s") application for certification

This document sets out Ofgem's final decision on I(UK)'s compliance with the requirements of the Third Package[2] for transmission system operators ("TSOs") to be certified in accordance with implementing legislation in Great Britain ("GB").

1. Certification Decision

Having taken utmost account of the European Commission's (the "Commission's") opinion on our preliminary certification decision on I(UK)[3] and its compatibility with Articles 9 and 10 of the Gas Directive, the Authority concludes that the sixth ground for certification set out in section 8G(8) of the Gas Act 1986 (the "Gas Act") has been complied with and that I(UK) should therefore be certified (on the basis of being in a substantially similar position to a person who benefits from an exemption under Article 22 of Directive 2003/55/EC (a "Second Package Exemption") and remains entitled to the benefit of it) until 2 March 2015, with certification continuing from 3 March 2015 on the first certification ground set out in section 8G(3) of the Gas Act, subject to conditions relating to the appointment/removal of directors and other senior officers and voting/access to information and should be designated as a TSO[4].

2. GB Legislation – Transposition of The Gas Directive

2.1. In GB the grounds for certification set out in the Gas Directive have been transposed through the Electricity and Gas (Internal Markets) Regulations 2011 (the "Regulations") which insert new sections 8C to 8Q into the Gas Act. Section 8G of the Gas Act sets out the grounds on which the Authority may decide to certify an applicant. The two grounds on which I(UK) applied for certification[5] are:

2.1.1. The sixth ground, which relates to gas interconnector licensees and provides that the Authority may decide to certify such an applicant on the basis of the applicant being in a substantially similar position to a person who has been granted a Second Package Exemption and remains entitled to the benefit of that exemption[6] (the "Substantially Similar Ground"); and,

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[1] In this document, the terms "Ofgem", "Authority", "we", "us" and "our" are used interchangeably. The "Authority" means the Gas and Electricity Markets Authority. "Ofgem" is the Office of the Authority.

[2] The term "Third Package" refers to Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC ("Electricity Directive"); Regulation (EC) No 714/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the network for cross-border exchanges in electricity and repealing Regulation (EC) No 1228/2003 ("Electricity Regulation"); Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC ("Gas Directive"); Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005 ("Gas Regulation"); and Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators.

[3] In accordance with Article 3(2) of the Gas Regulation.

[4] Pursuant to section 8J(2) of the Gas Act, implementing Article 10(2) of the Gas Directive.

[5] I(UK)'s application dated 30 November 2012 replaced the previous application for certification submitted on 11 November 2011, which was withdrawn.

[6] The second, alternative condition, as set out in section 8G(8)(b)(i) is "*the applicant has, in accordance with the conditions of that licence, been granted an exemption in accordance with Article 22 of Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 on common rules for the internal market in natural gas (new infrastructure) and remains entitled to the benefit of it ...*"

2.1.2. The first ground, which provides that the Authority may decide to certify an applicant on the basis that the applicant meets the ownership unbundling requirement in section 8H of the Gas Act (the "Ownership Unbundling Ground").

3. The Applicant

3.1. I(UK) (the "Applicant") owns and operates a sub-sea gas pipeline and terminal facilities which provide a bi-directional link between the United Kingdom ("UK") and Continental European energy markets (the "I(UK) interconnector"). The I(UK) interconnector comprises compression/reception terminals both at Bacton in the UK and Zeebrugge in Belgium, connected by a 235 kilometre, 40" pipeline which passes through British, Belgian and international waters. It is currently capable of transporting 20.0 billion cubic metres of gas per annum ("bcm/year") from Bacton to Zeebrugge and 25.5 bcm/year in the opposite direction. I(UK) was established in 1994 as a joint venture between nine energy companies - British Gas, Conoco, Gazprom, BP, Elf UK, Amerada, Distrigaz, National Power and Ruhrgas UK - for the purpose of building an undersea gas pipeline. All of these companies took both shareholding in I(UK) and capacity in the I(UK) interconnector in equal proportions under a Shareholders' Agreement and Standard Transportation Agreements ("STAs") which were signed on 16 December 1994. The I(UK) interconnector became operational on 1 October 1998 and I(UK) holds a gas interconnector licence granted under Section 7ZA of the Gas Act.

3.2. Since making its preliminary decision on 30 January 2013, the Authority has received a letter from I(UK) dated 18 March 2013, confirming that ConocoPhillips has transferred its entire shareholding to Fluxys Europe. The Authority has taken this change of shareholding into account in reaching its final certification decision.

3.3. This document provides a summary of the analysis of the information submitted by I(UK) to the Authority for the purpose of assessing the Applicant's compliance with the Substantially Similar Ground and with the Ownership Unbundling Ground set out in section 8G of the Gas Act and its certification under the GB legislation: (i) until 3 March 2015 on the basis of being in a substantially similar position to a person who has been granted a Second Package Exemption and remains entitled to the benefit of that exemption; and, (ii) continuing from 3 March 2015 on the Ownership Unbundling Ground, subject to conditions relating to the appointment/removal of directors and other senior officers and voting/access to information.

4. Summary of Ofgem analysis

Sixth certification ground: The Substantially Similar Ground

First limb: The applicant holds a licence under section 7ZA of the Gas Act

4.1. On 4 August 2006, the Department for Trade and Industry (authorised to act on behalf of the Secretary of State) granted I(UK) a gas interconnector licence under section 7ZA of the Gas Act, which came into force on 14 August 2006. As at the date of this decision, I(UK) continues to hold that licence (as amended) under section 7ZA of the Gas Act.

Second limb: Another person benefits from an exemption granted in accordance with the conditions of its licence under Article 22 of Directive 2003/55/EC (the "Second Gas Directive"), and the applicant is in a position which is substantially similar to the position of that person

4.2. I(UK) submits in its certification application that it is in a substantially similar position to BBL Company VOF (BBL), which benefits from an exemption under Article 22 of the Second Gas Directive in respect of part of its capacity.

4.3. The Authority is of the view that the comfort letter I(UK) received from the Commission in 1995 is not equivalent to an exemption under Article 22 of the Second Gas Directive. First, the comfort letter is merely an administrative decision and does not give rise to I(UK) acquiring legal rights enforceable against the world. Secondly, the processes for obtaining a comfort letter and an exemption under Article 22 of the Second Gas Directive are different, with additional criteria required to be satisfied for an exemption to be granted under Article 22 of the Second Gas Directive.

4.4. The Authority considers that the relevant test in determining whether the Applicant is in a substantially similar position to a person who benefits from an exemption under Article 22 of the Second Gas Directive is whether I(UK) would have been granted an exemption if the process under Article 22 of the Second Gas Directive had existed prior to the construction of the I(UK) interconnector. In GB the requirements of Article 22 of the Second Gas Directive were implemented by way of standard licence condition 12 of the gas interconnector licence, which sets out the tests to be applied for an exemption to be granted. We summarise our ex-post analysis of these tests below.

<u>First exemption test – the investment in the licensee's interconnector enhances competition in gas supply and enhances security of supply</u>

4.5. I(UK) states that its bi-directional pipeline increases the I(UK) interconnector's pro-competitive impact.

4.6. The Authority considers that the 40% share British Gas held in I(UK) at its inception would have been scrutinised in an ex-ante exemption analysis in terms of its potential to restrict competition. However, since British Gas may not have held a controlling interest in I(UK) it may have been that the 40% shareholding would have been deemed acceptable.

4.7. It is likely that prior to the construction of the interconnector (around 1994) we would have concluded that the I(UK) interconnector would have increased GB security of gas supply. This was because it was the first GB gas interconnector between the UK and Continental Europe; it opened up an alternative source of gas supply for the UK.

4.8. The I(UK) interconnector also provided a link to neighbouring markets, which in turn may have helped encourage investment in other gas infrastructure. In particular, the I(UK) interconnector may have played a role in facilitating the development of Liquefied Natural Gas ("LNG") terminals in the UK because the I(UK) interconnector ensured that there was a route to transport gas to the continent and that therefore the terminals would not be limited to meeting GB demand requirements[7].

4.9. In 1995 the design of the I(UK) interconnector was such that reverse flow capacity (Belgium to UK) was to be 42% of forward flow capacity[8]. This reflected the situation of the UK at the time as a potential gas exporter given estimated and confirmed gas resources in the UK continental shelf. Therefore, the I(UK) interconnector also increased security of gas supply for Belgium, France and Germany as they benefited

[7] At the time the I(UK) interconnector was built the UK did not have any capacity to accept large-scale LNG imports (the first LNG terminal was commissioned in 2005) and the Langeled pipeline to Norway did not begin operations until October 2006.

[8] The initial proposal was for the pipeline to be capable of UK export only, however, during the design of the project (and as evident from the Commission's comfort letter) it was decided that a limited UK import service should be constructed. Therefore, the initial forward flow capacity (UK to Belgium) was 20 bcm/year and the reverse flow capacity was 8.5 bcm/year.

from UK gas exports at a time when Western Europe was dependent on imports for approximately 40% of its gas requirements, which it obtained mainly from the former Soviet Union and Algeria.

4.10. In terms of the competition effects of the project, the Commission's XXVth Report on Competition Policy stated that "*... in view of the fact that [the I(UK) interconnector] will create opportunities for competition between markets which so far are quite isolated, the Commission found that the pro-competitive effects of the joint venture clearly outweigh the restrictions of competition. In its comfort letter, the Commission also ensured that the agreements will operate in practice in such a way as to effectively meet demand for any reverse flow capacity which may arise*."

4.11. It is therefore likely that we would have concluded that the I(UK) interconnector would, on balance, have enhanced competition and security of supply.

Second test – the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted

4.12. We consider it difficult to apply this second test retrospectively, since the I(UK) interconnector project did proceed without I(UK) having obtained an exemption under Article 22 of the Second Gas Directive.

4.13. However, it is clear that in order to proceed with the investment I(UK) did require some regulatory certainty. I(UK) stated in its withdrawn exemption application[9] that "*shareholders of I(UK) would have applied for an exemption had the mechanism been available to them at the time*"[10]. By seeking a competition law comfort letter from the Commission, I(UK) sought the only regulatory comfort which was available in 1995.

4.14. Regulatory certainty was strategically important for I(UK) in terms of the decision to make the initial investment and it would appear likely that the initial investment would not have been made absent a comfort letter from the Commission. This seems to satisfy the requirement set out in the 2004 Staff Working Paper on Exemptions to a certain degree which states: "*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*".

Third test – the interconnector will 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 system that infrastructure will be built

4.15. I(UK) is a registered company incorporated in England and Wales. Accordingly, I(UK) is an independent legal entity, separate from the two transmission systems to which it connects, namely, National Grid Gas's transmission system in the UK and Fluxys's transmission system in Belgium.

4.16. On 16 December 1994, I(UK)'s original shareholders entered into a Shareholders' Agreement to form the company and each also entered into a STA with I(UK) as shippers taking capacity. It appears that no single shareholder held a majority or controlling stake in the company.

[9] I(UK) submitted an application for an exemption under Article 22 of the Second Gas Directive on 2 March 2011. This application was subsequently withdrawn by I(UK).
[10] The system of exemptions was not instituted until 2004.

4.17. Distrigaz was the Belgian system operator, transmission system owner and domestic supplier in 1994. At this time Distrigaz owned Belco (with a 51% share), which was the legal entity set up to own and operate the Zeebrugge terminal assets. The establishment of Belco at the time was required under Belgian law, which stated that all gas facilities must be owned and operated by Distrigaz. However, Belco was separate in its legal form from Distrigaz and the Shareholders' Agreement provided that effective control of Belco was in the hands of I(UK).

4.18. It should be noted that Fluxys BV, an affiliate of Fluxys, and La Caisse de dépôt et placement du Québec ("CDPQ") have interests in both I(UK) and the connected Belgian transmission system. However, I(UK) states that there is complete separation from Fluxys in corporate terms and I(UK) has strict policies in place to ensure its commercial, financial and corporate independence from its shareholders. We are satisfied that there is complete separation between Fluxys and I(UK).

4.19. It is clear from the above that in 1994, which is approximately the time during which the exemption test would have been carried out, the I(UK) interconnector was owned by a natural or legal person which was separate in its legal form from the relevant system operators to whose systems the infrastructure would be connected. Therefore, it is highly likely that Ofgem would have concluded that this part of the exemption criteria would have been satisfied.

Fourth test – charges will be levied on users of the interconnector

4.20. Since its establishment I(UK) has not been a regulated entity, it has not and does not receive any regulated funding and is not funded in any way by consumers. All of I(UK)'s revenues are derived from standard and long term capacity contracts agreed with shippers. It is therefore highly likely that Ofgem would have concluded that this test was satisfied.

Fifth test – having any or all of the relevant [licence] conditions under consideration not in effect, or suspended from operation, is not detrimental to competition or the effective functioning of the internal gas market, or the efficient functioning of the regulated system to which the interconnector is connected

4.21. I(UK) had arrangements in place to allow shippers that did not enter into long-term contracts at the outset to purchase interconnector capacity which was available when I(UK) became operational. I(UK)'s pooling arrangements were likely to have been deemed as beneficial to new shippers in that they allowed shippers to access the I(UK) interconnector capacity on a firm basis for a defined period of time and they allowed for unused units to be bundled together. Although shippers were not required to offer unused capacity to the market, they had an incentive to do so given that they could generate revenue from subletting or selling unused capacity through the pooling system.

4.22. We note that the pooling arrangements only applied to new shippers who signed transportation agreements after 16 December 1994, if none of the initial shippers (with pre 16 December 1994 contracts) wished to sell capacity at the same time. Such an arrangement may have led to an increase in prices as it would reduce the supply of unused capacity for sale at any one time and shippers wishing to buy capacity could have been forced to pay high prices demanded by initial shippers because they could not get access to potentially lower priced capacity held by "newer" shippers.

4.23. We note that the Commission does not appear to have raised any concerns in response to the information set on this set out by I(UK) in its Form A/B notification and therefore it is likely that this could have provided a degree of comfort for I(UK) on

these arrangements. Nevertheless, whilst I(UK) did provide some arrangements for access to capacity in a secondary market, the fact that shippers could hold onto unused capacity if they wished to do so and the fact that some shippers were restricted from offering capacity for sale concurrently with initial shippers, may have been a concern if a pre-investment exemption analysis had been carried out.

4.24. Furthermore, the price for capacity was determined by the individual shippers and the process was not transparent - each shipper was able to determine the terms on which it was willing to make the capacity available and these were not divulged to any other person – this again may have been a potential issue which Ofgem and the Commission would have scrutinised as part of an exemption decision process and in respect of which Ofgem may have required more transparent arrangements to be introduced.

4.25. When comparing these arrangements to those required to be put in place by exempt interconnector licensees, they fall short of ensuring that unused capacity is offered to the market. Ofgem has required exempt interconnector licensees to put in place effective use-it-or-lose ("UIOLI") mechanisms, which require the licensee to offer, at least on an interruptible basis, unused capacity. We note that I(UK) is now required – through its interconnector licence - to put in place UIOLI arrangements and it has done so[11].

4.26. In relation to capacity enhancements, there were a number of options available to shippers who already held capacity in the I(UK) interconnector in terms of requesting capacity enhancement, both forward and reverse flow. Shippers who did not already hold I(UK) interconnector capacity could set in motion an investigation into forward flow enhancements. In addition, at the outset I(UK) made shippers aware of the possible availability of reverse flow capacity which they could develop at a cheaper than normal rate.

4.27. The arrangements for capacity enhancement favoured incumbent I(UK) shippers (just as incumbent shippers were favoured in terms of selling unused capacity) and this may have been an issue had an exemption test been carried out prior to the construction of the I(UK) interconnector. It is possible that I(UK) may have been required to agree transportation agreements that provided more of a level playing field for all shippers to purchase capacity and influence investments in enhanced capacity. In practice, reverse flow enhancements have been made, so the enhancement arrangements were functioning to a degree and have allowed reverse flow enhancements from 8.5 mcm/year in 1998 to the current 25.5 mcm/year.

Summary

4.28. We note that significant scrutiny and analysis of the permissible duration of any potential exemption would have been undertaken were we applying the relevant test in the context of an Article 22 exemption application prior to the construction of the I(UK) interconnector. We note that it is difficult to apply this level of scrutiny and analysis on a retrospective basis to an interconnector which has already been built. Applying the test retrospectively, we consider that it is appropriate to consider whether the exemption would be fundamentally inconsistent with the approach to Article 22 exemptions granted to similar projects. We also note that the duration of exemptions will vary from project to project and that the Commission has imposed a number of conditions on entities receiving exemptions.

[11] UIOLI being a mechanism whereby any unused capacity can be sold to other shippers on an interruptible basis.

4.29. It is not possible, on the basis of the evidence which we have, to conclude what length of exemption may have been granted because it is not possible for the Authority to assess what it would have done prior to the I(UK) interconnector's construction now. The next best alternative is for us to say what we may have done prior to the construction of the I(UK) interconnector.

4.30. Therefore, our opinion is that it is possible that Ofgem could have granted I(UK) an ex-ante exemption until 3 March 2015. We note however, that any decision the Authority would have made would have been subject to the views of the Commission which holds the right of veto on exemption decisions. It is even less possible for the Authority to surmise what the Commission may have concluded at the time.

4.31. Given that I(UK) has stated in its certification application that it is taking steps to be compliant with the Ownership Unbundling Ground from 3 March 2015 we deem it unnecessary to undertake a more detailed retrospective analysis of the possible time period of exemption that I(UK) may have been granted.

First certification ground: The Ownership Unbundling Ground

4.32. I(UK) states it will comply with the Ownership Unbundling Ground by 3 March 2015. I(UK) recognises that its current corporate arrangements do not comply with this certification ground. The transitional phase of seeking certification under the Substantially Similar Ground until 2 March 2015, will (in I(UK)'s view) be sufficient to allow I(UK) to make the necessary changes to its corporate arrangements to comply with the Ownership Unbundling Ground from 3 March 2015.

4.33. In the Transition Plan included in its certification application, I(UK) says that it will undertake to provide Ofgem with reports on progress towards compliance with the Ownership Unbundling Ground and towards compliance with additional conditions to be imposed by Ofgem. The reports will be provided every three months (or by exception when material events occur which I(UK) believes represent a significant milestone). Such reports will set out an update for the preceding 3 months and expected progress for the following 3 months.

4.34. The changes which I(UK) is making to its corporate governance relate to the ring-fencing of the appointment/removal of directors and voting/information rights with regard to a new category of conflicted shareholders. These changes are reflected by conditions in the Authority's final decision.

4.35. The conditions the Authority is including in its final certification decision can be summarised as follows:

a. I(UK) must report to the Authority quarterly, setting out the steps taken and being taken to pass the ownership unbundling tests set out in section 8H of the Gas Act and setting out the date by which each step was completed, or will be completed. This will help the Authority assess whether I(UK)'s certification should continue on the Ownership Unbundling Ground from 3 March 2015.
b. Before 3 March 2015, I(UK) must ensure that:
    i. any directors, or other senior officers, appointed by a conflicted shareholder[12] have been removed from the board of directors, any board committees any other administrative bodies of I(UK);

[12] Ie any shareholder of I(UK) which: (a) is a relevant producer or supplier (within the meaning of the Gas Act); and/or (b) directly or indirectly controls or has a majority shareholding in a relevant producer or supplier; and/or (c) is directly or indirectly controlled by a person who: (i) is a relevant producer or supplier; and/or (ii) directly or

ii. any director, or other senior officer who participates in the appointment of other directors or senior officers of i(UK) is not also a senior officer of a relevant producer or supplier;
iii. no conflicted shareholder, or proxy, is entitled to participate in the appointment process for I(UK)'s directors, senior officers, or members of any of I(UK)'s board committees;
iv. no conflicted shareholder, or proxy, attends any I(UK) shareholder meeting (or part of such a meeting), unless the meeting (or part) receives information on, or discusses, any matter(s) which I(UK)'s board of directors has previously determined is highly likely to have a material impact on I(UK)'s dividends;
v. no conflicted shareholder, or proxy, votes at a meeting of I(UK)'s shareholders unless the matter being voted on has previously been determined by I(UK)'s board of directors as highly likely to have a material impact on I(UK)'s dividends. This is without prejudice to sections 8O and 8P of the Gas Act;
vi. no conflicted shareholder, or proxy, is provided with (or given access to) information/documentation by any other shareholder, I(UK) director, I(UK) employee, or any representative of I(UK) unless the information/documentation relates to decisions taken by I(UK)'s board or shareholders, financial reports, forecasts and accounts and audit reports, or a matter which I(UK)'s board of directors has determined is highly likely to have a material adverse impact on I(UK)'s dividends. This is without prejudice to sections 8O and 8P of the Gas Act.

c. At the first I(UK) board meeting after certification, and again after any change in shareholdings in I(UK), I(UK)'s board of directors must determine whether there are any conflicted shareholders and send a copy of the decision to the Authority within 7 working days.
d. I(UK) must establish and maintain a compliance programme to review and report quarterly to the Authority on I(UK)'s adherence to the conditions in the certification decision.
e. I(UK)'s compliance programme shall include (but shall not be limited to):
    i. Maintaining copies of the information/documentation withheld from and provided to (in the limited circumstances above) any conflicted shareholders;
    ii. Keeping a register recording:
        1. details of the meetings (including dates and decisions) from which conflicted shareholders have been excluded; and,
        2. each occasion where the caveat permitting involvement of a conflicted shareholder has been applied, including details of the name(s) of the conflicted shareholder(s); the date on which I(UK)'s board of directors determined that a matter was highly likely to have a material impact on I(UK)'s dividends and the reasons for that decision; the date when the conflicted shareholders received information/documentation or participated in a shareholder meeting; and details of the relevant meetings and information/documentation received/given.
f. I(UK) must notify the Authority in writing within 7 working days of any change in shareholdings, including but not limited to the registered name(s) and company number(s) of any new shareholders; the number and type of shares allotted or transferred; the percentage of the total shareholding in I(UK) that each new shareholder holds; and any reduction or increase in

indirectly controls a person who is a relevant producer or supplier; and/or (iii) is directly or indirectly controlled by a person who is a relevant producer or supplier.

shareholding by any current I(UK) shareholder (including the number and type of shares allotted or transferred and the percentage of the total shareholding in I(UK) held by the relevant I(UK) shareholder).

g. If at any time the Authority considers that any of these conditions is not met, I(UK) must give the Authority in such manner and at such times as the Authority may reasonably require the reasons for the breach and the details of any steps being taken to rectify the breach (including timescales) together with any supporting documentation.
h. I(UK) must give the Authority in such manner and at such times as the Authority may reasonably require, such information as the Authority may reasonably require, or as may be necessary, for the purpose of considering the quarterly reports made by I(UK) as summarised above.

4.36. We welcome I(UK)'s identification of areas where it does not currently pass all of the ownership unbundling tests set out in section 8H of the Gas Act and commitment to implement changes, which I(UK) believes, will result in I(UK) passing these tests. Whilst we are unable to assess whether the proposed changes will result in I(UK) complying with these test and the additional conditions until they have been made (as they may be subject to change, or require consequential amendments to other documents to render them effective), our initial analysis indicates that the proposed changes are broadly compatible with the main principles of the Ownership Unbundling Ground.

4.37. I(UK) will need to submit relevant analysis closer to, but before 3 March 2015, to demonstrate that it complies with all of the tests set out in section 8H of the Gas Act and with the additional requirements summarised above as at 3 March 2015. This is reflected in the conditions to I(UK)'s certification.

4.38. If I(UK) complies with the conditions contained within the Authority's decision and the Authority considers that the Ownership Unbundling Ground and the additional conditions are satisfied at 3 March 2015, I(UK) will continue to be certified after 3 March 2015. This will mean that I(UK) must implement and adhere to all points of Annex F of its certification application and the final version of Annex G of its certification application as well as adhere to the conditions summarised above and pass all of the tests set out in section 8H of the Gas Act if I(UK) is to remain certified after 3 March 2015.

4.39. If, prior to 3 March 2015 Ofgem believes that I(UK) is unlikely to comply with the tests set out in section 8H of the Gas Act and with the additional conditions by 3 March 2015, Ofgem will write to inform I(UK) of its assessment and may ask I(UK) to provide an explanation. In the event that the Authority does not think that I(UK) complies with each of the tests set out in section 8H of the Gas Act as at 3 March 2015, the Authority reserves its right to review and, if appropriate, withdraw certification.

4.40. We consider that the conditions summarised above should apply equally to I(UK)'s wholly owned subsidiary Interconnector Leasing Company Limited ("ILC") and note that the unbundling rules apply to ILC, as owner of part of the infrastructure at Bacton.

4.41. Finally, as I(UK) does not benefit from an exemption under Article 22 of the Second Gas Directive, I(UK) must (in addition to the above) act in compliance with the relevant European Network Codes adopted pursuant to the Gas Regulation as they enter into force and in compliance with other relevant provisions of the Gas Directive and of the Gas Regulation.

5. European Commission Opinion

5.1. Pursuant to Article 3(2) of the Gas Regulation, Ofgem is required to take "utmost account" of the Commission's opinion as to the compatibility of the preliminary decision with Articles 9 and 10 of the Gas Directive in reaching its final certification decisions. We summarise below how we have taken "utmost account" of the Commission's opinion of Ofgem's preliminary certification decision in relation to I(UK). The Authority understands from the Commission that this opinion was published on the Commission's website and can be viewed at: http://ec.europa.eu/energy/gas_electricity/interpretative_notes/doc/certification/certifications_decisions.pdf.

5.2. The Commission agreed with the Authority's view that the comfort letter received by I(UK) in 1995 cannot be considered to be equivalent to an exemption granted under Article 22 of the Second Gas Directive.

5.3. The Commission noted that the Substantially Similar Ground and the test applied by the Authority in certifying I(UK) is not expressly set out in the Gas Directive or the Gas Regulation and it therefore does not consider it necessary for it to engage in this analysis as the ground is specific to GB transposing legislation.

5.4. The Commission concluded that I(UK) is not part of a vertically integrated undertaking, but that *"more than one person who controls production or supply undertakings currently does exercise rights in relation to I(UK), specifically rights to appoint Directors and the right to exercise voting rights"*, which is not in compliance with Article 9(1)(b)(i) or Article 9(1)(c) of the Gas Directive. The Commission noted that it is possible that *"persons [could currently be] appointed as Directors of I(UK) who are simultaneously members of the supervisory board, the administrative board or bodies legally representing production or supply undertakings"*, which is contrary to Article 9(1)(d) of the Gas Directive. The Commission also noted that I(UK) included proposals to remedy these 'deficiencies' by 3 March 2015 in its certification application and that the Authority proposed in its preliminary decision to impose conditions relating to these proposals in its final decision.

5.5. The Commission concluded that if I(UK) complies with its proposals and the conditions which the Authority proposed to include in its final decision, the requirements of Articles 9(1)(b)(i), 9(1)(c) and 9(1)(d) of the Gas Directive would be complied with and the Commission supported the Authority including the proposed conditions in its final decision.

5.6. The Commission *"recognise[d] the particular situation of [I(UK)], which has acted as [an] important link between British and continental European markets for years and which in many respects was at the forefront of the introduction of flexible and transparent gas transport arrangements in the internal energy market. The Commission recognises that this infrastructure was built at a time when different and more limited unbundling rules applied and when the current system of exemptions for new infrastructure was not in place. The Commission acknowledges that, in this case, an abrupt removal of rights from conflicted shareholders in [I(UK)] could lead to difficulties in corporate governance and would not be proportionate given the uncertainty which the shareholders had as regards the applicability of unbundling rules given the comfort letter ... and the provisions of UK law. A transition period of two years in these specific circumstances is reasonable. Moreover, a transition period to 2015 ensures that [I(UK)] will be fully unbundled when new contracts are negotiated to apply following the expiry of the existing contracts in 2018."* The Authority considers this to be supportive of the transitional certification of I(UK) on the Substantially Similar Ground.

5.7. The Commission highlighted the importance of ensuring effective unbundling is fully implemented as soon as possible and invited the Authority (if it considers implementation could be achieved before 3 March 2015) to require compliance with the ownership unbundling tests set out in section 8H of the Gas Act by an earlier date. The Commission also supported the Authority's proposed condition requiring quarterly progress reports on such compliance. The Authority will monitor I(UK)'s progress towards compliance with the conditions set out in its final decision and I(UK) is obliged (by way of a condition in the Authority's final decision) to report quarterly to the Authority on this point. The Authority encourages prompt compliance with the conditions set out in its final decision.

5.8. Further, we note that non-compliance with the conditions set out in our decision is a ground for withdrawal of certification. We therefore consider it appropriate to issue our final decision and require I(UK) to commence reporting to us on its compliance with the conditions set out in our decision (commencing three months from the date of this decision), enabling us to take prompt action in the event of any non-compliance.

5.9. The Commission *"considers that the rules relating to full ownership unbundling apply equally to the subsidiary companies of [I(UK)]"*.