

Current and future electricity transmission; gas transportation; electricity interconnector; and gas interconnector licensees

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Dear Colleague,

Certification arrangements in Great Britain following 2017 amendments to the ownership unbundling requirements of the Gas Act 1986 and the Electricity Act 1989: Removal of EEA limitation from the definition of Relevant Producer or Supplier and approach to the application of Ofgem's discretion

This letter sets out information on our intended approach to processing applications for certification and undertaking reviews of certification following recent amendments to the ownership unbundling provisions of the Electricity Act 1989 ('the Electricity Act') and Gas Act 1986 ('the Gas Act'), as detailed in Annex 1 to this letter. The amending regulations, the Electricity and Gas (Internal Markets) Regulations 2017 ('the 2017 Regulations'), came into force on 24 April 2017¹.

The 2017 Regulations amend the transposition of the EU unbundling requirements into GB legislation and require that that production, generation and supply activities carried out both within and outside the European Economic Area (EEA) must now be considered as part of the five certification tests. Previously, only production, generation and supply activities located in the EEA were considered as part of the five certification tests.

The changes affect the following types of licensee in Great Britain ('GB'): (i) electricity transmission; (ii) gas transportation (high-pressure only); (iii) electricity interconnector; and, (iv) gas interconnector. Annex 1 to this letter explains the changes and their impact on TSOs currently certified as fully ownership unbundled and new certification applicants.

Our open letter of 15 March 2015 first set out our approach to exercising our discretion to treat the five unbundling tests as passed under section 10F(9A) of the Electricity Act and 8H(9A) of the Gas Act. This letter now updates and supersedes that letter. It is important that you read Annex 1 to this letter carefully and consider any steps you may need to take as a result.

We encourage applicants to seek legal advice on applying the legislation to their specific circumstances. Please email unbundlingcertification@ofgem.gov.uk if you have any questions about the certification process.

Yours sincerely,

Akshay Kaul
Partner, Networks

¹ http://www.legislation.gov.uk/uksi/2017/493/pdfs/uksi_20170493_en.pdf

Annex 1 - Certification arrangements in Great Britain following amendments to the ownership unbundling requirements of the Gas Act 1986 and the Electricity Act 1989: Removal of EEA limitation from the definition of Relevant Producer or Supplier and approach to the application of Ofgem's discretion

1. Summary

EU legislation requires ownership 'unbundling'. Unbundling means separating the ownership and operation of a transmission network from the activities of electricity generation, gas production and energy supply.

The government recently made some changes to the ownership unbundling provisions of the Electricity Act 1989 ('the Electricity Act') and Gas Act 1986 ('the Gas Act'). The amending regulations, the Electricity and Gas (Internal Markets) Regulations 2017, came into force on 24 April 2017² ('the 2017 Regulations').

The Authority³ is responsible for administering the certification process in Great Britain ('GB') in accordance with the unbundling requirements of the Third Package.⁴ Although there are a number of certification grounds, ownership unbundling is the only ground affected by the 2017 Regulations and is the only certification ground considered here. Those applying for certification under the ownership unbundling ground⁵ must pass five tests⁶ for certification to be granted, and must continue to meet these tests to retain certification. Where one or more of these tests is failed, an applicant can be certified under this ground if the Authority exercises its discretion to treat these tests as passed,⁷ where it is satisfied that there is no risk of discrimination and it would be in line with our principal objective and general duties to do so (the 'discretionary power').

The 2017 Regulations amend the transposition of the EU unbundling requirements into GB legislation. It amends the definition of Relevant Producer or Supplier ('RPOS') by removing the EEA geographical limitation on production, generation and supply activities, so that a person undertaking those activities anywhere in the world may now fall within the definition of RPOS. As a result, production, generation and supply activities both within and outside the EEA must now be considered as part of the five certification tests. Previously, only production, generation and supply activities carried out within the EEA were considered as part of the five certification tests.

This document outlines the changes introduced by the 2017 Regulations and explains our approach to the application of our discretion. This document is not a substitute for the requirements of the legislation. We encourage applicants to seek legal advice on applying the legislation to their specific circumstances.

The 2017 Regulations apply to all new applications for certification received on or after 24 April 2017. Transitional arrangements apply to transmission system operators ('TSOs')⁸ that are certified as fully ownership unbundled before 24 April 2017, and are set out in section 6 of Annex 1 and section 7 of the 2017 Regulations.

² http://www.legislation.gov.uk/ukxi/2017/493/pdfs/ukxi_20170493_en.pdf

³ The Gas and Electricity Markets Authority ('the Authority'). In this document, the terms 'Authority', 'Ofgem', 'we' and 'us' are used interchangeably.

⁴ 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 ('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 ('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 ('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 ('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. It entered into force on 3 September 2009.

⁵ Section 10E(3) of the Electricity Act and section 8G(3) of the Gas Act.

⁶ Sections 10F(2)-(6) and (8) of the Electricity Act and sections 8H(2)-(6) and (8) of the Gas Act.

⁷ Section 10F(9A) of the Electricity Act and section 8H(9A) of the Gas Act.

⁸ 'Transmission system operator' means a natural or legal person responsible for operating, ensuring the maintenance of and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the transmission of electricity. This definition is set out in Article 2(4) of the Electricity and Gas Directives.

2. Background

EU legislation requires the ownership unbundling of TSOs. Unbundling means separating the ownership and operation of a transmission system from the activities of electricity generation, gas production and energy supply. One of the aims of the provisions is to make sure that TSOs take their decisions independently, ensuring transparency and non-discrimination towards all network users.

The Electricity and Gas (Internal Markets) Regulations ('the 2011 Regulations'), which came into force on 10 November 2011, transposed the EU unbundling requirements into domestic law and provided the current legal framework for the structural separation of TSOs in GB.⁹ Our open letter of 10 November 2011¹⁰ detailed our procedure for processing applications for certification under the ownership unbundling requirements of the Third Package.¹¹ Under the Electricity Act and the Gas Act, gas and electricity interconnector, electricity transmission and certain gas transporter licensees are required to be certified.¹²

The Electricity and Gas (Ownership Unbundling) Regulations 2014,¹³ which came into force on 15 January 2015, amended the transposition of the EU unbundling requirements to allow us to treat one or more of the five unbundling tests as passed if we are satisfied that there is no risk of discrimination and it would be in line with our principal objective and general duties to do so. Our open letter of 6 March 2015 set out those amendments;¹⁴ please note that this guidance replaces and supersedes the guidance attached to that letter

3. An overview of the GB legal framework

Although the 2017 Regulations change the definition of RPoS, the five certification tests and our approach to exercising the discretionary power have not changed. The five tests, as set out in the legislation, are:

- **First test:** the applicant
 - a) does not control a relevant producer or supplier ('RPoS');
 - b) does not have a majority shareholding in a RPoS; and
 - c) will not, on or after the relevant date,¹⁵ exercise shareholder rights in relation to a RPoS.
- **Second test:** if the applicant is a company, partnership or other business, none of its senior officers has been, or may be, appointed by a person who—
 - a) controls an undertaking¹⁶ which is a RPoS; or
 - b) has a majority shareholding in an undertaking which is a RPoS.
- **Third test:** if the applicant is a company, partnership or other business, none of its senior officers is also a senior officer of an undertaking which is a RPoS.
- **Fourth test:** the applicant is not controlled by a person who controls a RPoS.
- **Fifth test:** the applicant is not controlled by a person who has a majority shareholding in a RPoS.

⁹ There was a separate transposition for Northern Ireland.

¹⁰ <https://www.ofgem.gov.uk/ofgem-publications/59314/111110-open-letter-certification-post-legislation.pdf>. Please note that Ofgem is currently reviewing the format of certification applications, and we will communicate any updates to the procedure described in this letter in due course.

¹¹ As amended by the Electricity and Gas (Internal Markets) Regulations 2011.

¹² Section 10A of the Electricity Act and 8C of the Gas Act.

¹³ http://www.legislation.gov.uk/uksi/2014/3333/pdfs/uksi_20143333_en.pdf

¹⁴ <https://www.ofgem.gov.uk/publications-and-updates/certification-arrangements-great-britain-following-amendments-ownership-unbundling-requirements-gas-act-1986-and-electricity-act-1989>

¹⁵ Section 10A(4) of the Electricity Act and 8C(4) of the Gas Act.

¹⁶ The definition of "electricity undertaking" is set out in Section 100(2) of the Electricity Act. The definition of "gas undertaking" is set out in Section 8Q(2) of the Gas Act.

Who is an applicant?

In this document we refer to persons applying for certification (under section 10B(1) of the Electricity Act or section 8D(1) of the Gas Act) and those whose certification is being reviewed (under section 10I(3) or (5) of the Electricity Act or section 8K(3) or (5) of the Gas Act) collectively as 'the applicant'. To date, all applicants for certification have been either current or prospective electricity transmission licensees (onshore and offshore), electricity interconnector licensees, gas transporter licensees (who carry out the activity of transmission) and gas interconnector licensees.

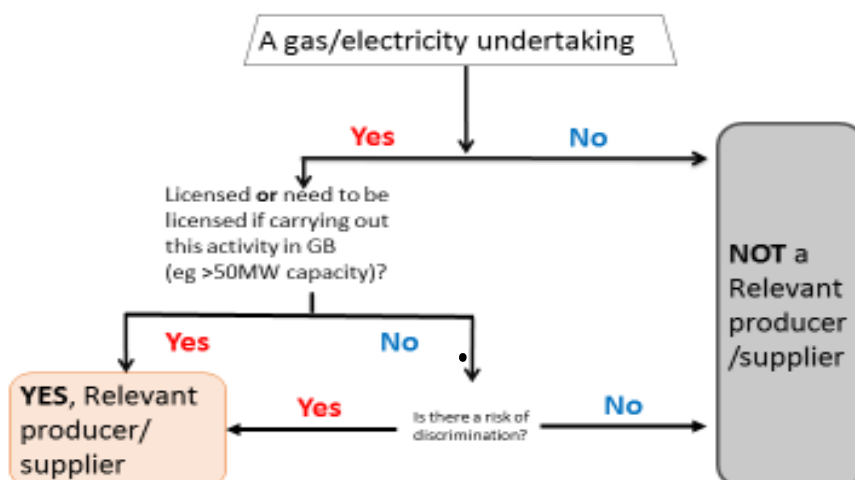
Who is a relevant producer or supplier ('RPOS')?

The relationship between the applicant and the RPOS is at the heart of each of the five certification tests. A RPOS is anyone who participates in one or more of the activities of electricity generation, gas production and/or energy supply either within or outside the European Economic Area (EEA) and

- Requires or, in the Authority's opinion, would require a licence to carry out that activity or activities in GB; or
- does not require a licence, or is operating under an exemption granted by the Secretary of State, but has a relationship with the applicant which we think might lead the applicant to discriminate in favour of that person.

This definition is set out in Section 100(3)-(5) of the Electricity Act and sections 8Q(3)-(5) of the Gas Act. There is an illustration of the term RPOS in Figure 1 below.

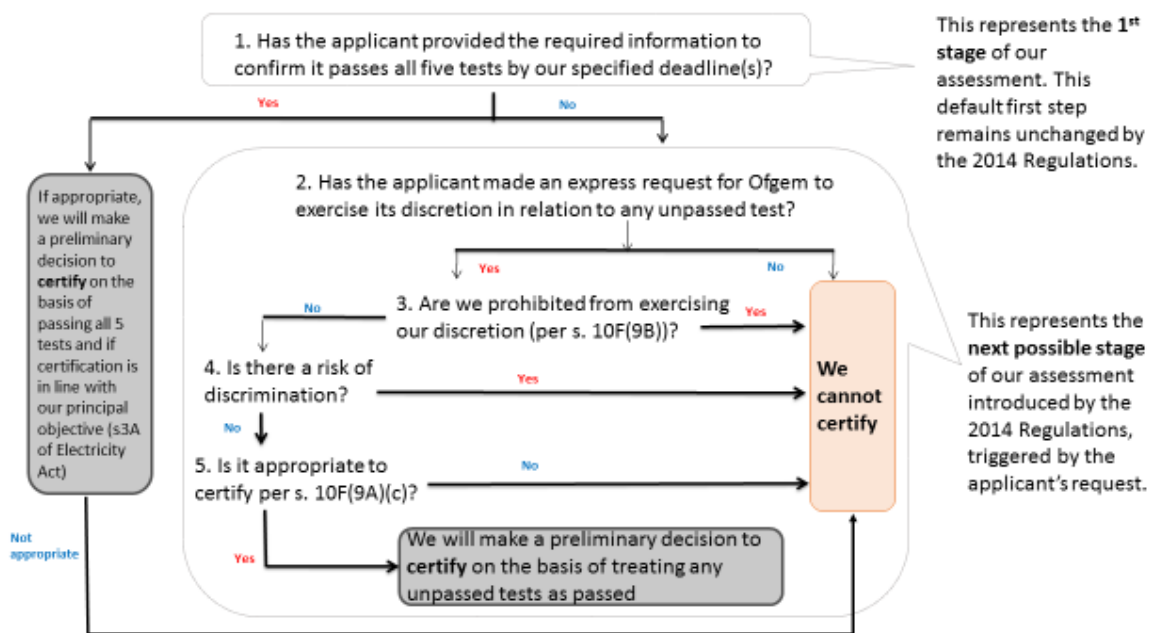
Figure 1: Illustration of the term "Relevant producer or supplier" within the meaning of section 100 of the Electricity Act and section 8Q of the Gas Act



What is risk of discrimination?

Our assessment of risk of discrimination refers to whether an applicant has a relationship with a RPoS which might lead the applicant to discriminate in favour of the RPoS.

Figure 2 – Overview of certification assessment under the Electricity Act
(apart from step 3, this chart also applies to applications for certification under the Gas Act)



4. What has changed?

In its letter of 23 February 2017,¹⁷ the Department for Business, Energy & Industrial Strategy ('BEIS') (formerly DECC) explained that the Commission had communicated its concerns over the GB transposition of the unbundling requirements, specifically that consideration of production, generation and supply activities was limited to those taking place within the European Economic Area ('EEA').

BEIS noted that the Commission's principal concern was that other Member States that have borders with non-EEA states may see the GB transposition as setting a precedent they can use, risking potential discrimination and anti-competitive behaviour as a result of unbundling decisions their territories. The Commission have made it clear that they do not have any concerns over any individual unbundling certification decisions made to date in GB.

Accordingly, the 2017 Regulations amend the definition of Relevant Producer or Supplier ('RPoS') and, as a result, production, generation and supply activities, regardless of where they are located, must be considered as part of the five certification tests. As such, when assessing applications, we will now take into account production, generation and supply activities that take place both within and outside the EEA.

¹⁷ https://www.ofgem.gov.uk/system/files/docs/2017/02/tso_unbundling_letter_-_forpublication_0.pdf

Our discretion to treat one or more of the five tests as passed and our general approach to assessing the risk of discrimination, set out below in section 8, has not changed.

5. Impact on new applicants

The changes will apply to all new applications received on or after 24 April 2017. When assessing whether new applicants pass the five tests, we will take into account production, generation and supply interests both within and outside the EEA.

We will also take production, generation and supply interests taking place both within and outside the EEA into account in assessing the risk of discrimination where the applicant has asked us to exercise our discretion to treat one or more of the tests as passed.¹⁸

6. Impact on currently certified persons: transitional arrangements

BEIS has implemented transitional arrangements for TSOs that were certified before the 2017 Regulations came into force, i.e. before 24 April 2017.¹⁹ It is not intended that this amendment will itself trigger a review of certification. Rather, a review will only be triggered if and when a later trigger event occurs. This means that a review would only be triggered where there is a change in production, generation or supply interests within the EEA or if a review is otherwise necessary in accordance with Section 10I of the Electricity Act or Section 8K of the Gas Act.

As such, TSOs certified before 24 April 2017 are not required to notify us of production, generation and supply interests outside the EEA unless they consider that a specific event or circumstance (e.g. an acquisition or divestment of production or supply interests within the EEA) might affect their certification or the Authority specifically requests this information.

7. Review process

Ofgem can review certification where we consider that a TSO's current certification basis may no longer apply, or where requested to do so by the European Commission. We will open a review where there is evidence that a change in circumstance may cause a TSO to fail any of the tests or there may be a risk of discrimination.

Certified TSOs have an obligation to advise the Authority of any changes that may affect their eligibility for certification. Certified TSOs can also trigger a review by notifying us of changes under section 10I(5)(a) of the Electricity Act or Section 8K(5)(a) of the Gas Act.

As noted in section 6, in respect of TSOs certified before 24 April 2017 we consider that changes to production, generation or supply interests taking place within the EEA would trigger a review of certification, while changes to such interests outside the EEA would not trigger a review. However, once a review is triggered, we will take into account any generation and supply interests both within and outside the EEA when considering whether the five tests continue to be passed and, where specifically requested, whether we can exercise our discretion.

8. The discretion to treat one or more of the five tests as passed

Section 10F(9A) of the Electricity Act sets out how the discretion applies to applicants under that Act, unless the exception in subsection (9B) applies.²⁰ Subsection (9B) relates to circumstances where the Authority is prohibited from exercising its discretion. This is discussed in more detail later in this section.

¹⁸ <https://www.ofgem.gov.uk/publications-and-updates/certification-arrangements-great-britain-following-amendments-ownership-unbundling-requirements-gas-act-1986-and-electricity-act-1989>

¹⁹ Section 7 of the 2017 Regulations applies.

²⁰ To note, we are still able to treat the fourth and fifth tests as passed in specific circumstances and for a specified period of time under subsections 10F(7) and 10F(9) of the Electricity Act and 8H(7) and 8H(9) of the Gas Act

Section 10F9(A) states:

“(9A) Except where subsection (9B) applies, the Authority may treat one or more of the five tests in this section as passed if—

- (a) the test or tests are not passed in relation to a relevant producer or supplier,
- (b) the applicant has demonstrated to the Authority’s satisfaction that the applicant does not have a relationship with the relevant producer or supplier which might lead the applicant to discriminate in favour of the relevant producer or supplier, and
- (c) the Authority thinks it appropriate to treat the test or tests as passed.”

Section 8H(9A) of the Gas Act sets out how the discretion applies to applicants under that Act, shown below.

“(9A) The Authority may treat one or more of the five tests in this section as passed if—

- (a) the test or tests are not passed in relation to a relevant producer or supplier,
- (b) the applicant has demonstrated to the Authority’s satisfaction that the applicant does not have a relationship with the relevant producer or supplier which might lead the applicant to discriminate in favour of the relevant producer or supplier, and
- (c) the Authority thinks it appropriate to treat the test or tests as passed.”

General approach

Below we describe our general approach to exercising the discretion according to the above provisions. Unless otherwise stated, this approach applies equally to all applicants for certification under the ownership unbundling ground.

- a) For applicants under the Electricity Act only, we are prohibited from exercising the discretion to treat one or more of the five tests as passed where the circumstances discussed in section 10F(9B) apply. This is discussed further below.
- b) Where the circumstances in (a) do not apply, the starting point remains that an applicant who does not meet all five tests will not be certified. The onus is on the applicant to ask us to consider exercising the discretion. We expect the applicant to:
 - i. expressly request that we consider exercising our discretion, and reference the particular test or tests which are not passed.
 - ii. detail the reasons why it believes that there is no risk of discrimination in the particular circumstances.
 - iii. provide information to support its explanation. The nature of such information will depend on the particular test or tests that the applicant is asking us to treat as passed and the circumstances of each individual case, but the following may be relevant:
 - Corporate governance arrangements between the applicant and the RPoS, such as details of shareholder agreements and corporate charts.
 - Information to confirm the size and physical location of the relevant assets such as maps or grid references and copies of connection agreements.
 - Other evidence such as copies of licence documents, export capacity agreements and exporting market details.

Unless we are satisfied, on the basis of the information received, that the applicant does not have a relationship with the RPoS which might lead the applicant to discriminate in favour of that RPoS, the applicant will not be certified.

- c) To decide whether it is appropriate to treat the tests as passed, we will need to consider the wider circumstances of the application by having regard to our principal objective and general duties.

Risk of discrimination

This section lists the factors that we consider may be particularly relevant to assessing the risk of discrimination and our ability to exercise discretion.

Each case will be assessed on its merits, taking into account the context and conditions likely to affect the competitiveness of the energy markets in which the applicant and the RPoS operate. No factor alone will be decisive and further factors may be relevant.

- **Geographical proximity of the assets under the ownership or operational control of the applicant and the RPoS' assets.** The closer the two are, the stronger the indication that a risk of discrimination may exist and the stronger the evidence we will require to rebut it. The risk of discrimination is likely to be greater when the applicant's and RPoS' assets are both located in GB. Conversely, the risk is likely to be lower when the assets are not in the same or a neighbouring market.
- **Role carried out by the applicant.** Each type of licensee has a different role in the GB energy market. Some have an extensive range of responsibilities in operating a large integrated network and establishing the commercial terms for access to a network, and have some influence over investment planning decisions. Others have a more limited range of activities relating to a point-to-point system, which connects to the larger integrated network. The more activities performed by the licensee, the greater the risk of discrimination and the stronger the evidence we will need to rebut it. We consider the risk of discrimination greater if the applicant carries out significant system operation functions or is responsible for investment planning in the geographical area in which the RPoS connects.
- **Market share of electricity generation, gas production and energy supply activities concerned.** We will be particularly concerned about the risk of discrimination if an applicant, or a controller of the applicant, has a relationship which amounts to control over a RPoS, or some RPoS' collectively, who has a large share of the market that both the applicant and the RPoS are active in. The greater the market share, the easier it is to create an opportunity for discrimination, and the stronger the evidence we will require to rebut it. The information gathered as part of this assessment may also be used as part of a broader assessment of potential market power, if necessary. For example, our concerns about the risk of discrimination may be moderated by evidence of the extent to which the RPoS is a price-taker in the relevant market or is insensitive to wholesale market fluctuations.
- **Type of energy assets operated.** We consider that the likelihood of discrimination would be greater when the applicant and the RPoS operate assets in the same sector (i.e. electricity or gas) than otherwise. We may also consider whether the gas production, electricity generation or energy supply activity is the result of a by-product of another primary operation, and whether this affects the risk of discrimination.
- **Arrangements governing the relationship between the applicant, or its controller, and the RPoS.** For example, we are likely to have particular concerns about the risk of discrimination where an applicant, or its controller, has access to confidential information on the activities of a RPoS which has the potential to weaken the scope for investment across the sectors where both the applicant and the RPoS(s) are active.

Appropriateness

As noted above, the Authority will also consider whether it is appropriate to treat the relevant tests as passed by having regard to our principal objective and general duties.

Circumstances where the Authority is prohibited from exercising its discretion

Subsection 10F(9B) contains the following exception for applicants under the Electricity Act:

“This subsection applies where the applicant, or a person who controls or has a majority shareholding in the applicant, controls or has a majority shareholding in a person (“A”) who operates a generating station and—

- (a) A is a relevant producer or supplier; and
- (b) the generating station is directly physically connected to anything that forms part of the applicant’s transmission system or electricity interconnector.”

In the September 2014 call for comments, DECC (now BEIS) explained that this exception is appropriate as certification cannot be granted in these specific circumstances because: *“there would always and necessarily be an unacceptable risk of discrimination in such a situation, i.e. if an electricity TSO were not ownership unbundled from a generator to which it is directly physically connected.”*

An example of a scenario where we would be prohibited from exercising the discretion is where the same person controls, or has a majority shareholding in, an offshore transmission asset and a generating station connected to it.

9. Other relevant legislation and regulation

We remind applicants and certified persons that, notwithstanding their certification status, they must continue to comply with all legal requirements applicable to them, including licence conditions.

If you have any queries please contact unbundlingcertification@ofgem.gov.uk