Sean Waring
Managing Director
Interconnector (UK) Limited
4th Floor, 10 Furnival Street
London
EC4A 1AB

Making a positive difference
for energy consumers

CC. Marie-Pierre Fauconnier,
President of the Commissie voor de Regulering
van de Elektriciteit en het Gas, Belgium

Direct Dial: 0203 263 9670
Email: Natasha.Zoe.Smith@ofgem.gov.uk
Date: 28 February 2018

Dear Sean

Authority decision to approve proposed modifications to Interconnector (UK)'s Charging Methodology

On 5 December 2017, Interconnector (UK) ('IUK') proposed modifications to its Charging Methodology to the Authority[1] for approval, pursuant to Standard Licence Condition ('SLC') 10 of the Gas Interconnector Licence ('the Licence').[2] The most significant of these changes proposes a tariff setting and publication regime. In order to implement the proposed tariff setting and publication regime, IUK has also requested that we issue a direction pursuant to SLC10(15) of the Licence, permitting it to vary its Charging Methodology Statement in accordance with the proposed Charging Methodology. In a separate application, IUK is also seeking a derogation from aspects of Commission Regulation (EU) 2017/460 establishing a network code on harmonised transmission tariff structures for gas ('TAR') that IUK would otherwise be required to comply with by 31 May 2019.

After careful consideration, we have decided to approve the proposed modifications to IUK's Charging Methodology, and to direct that IUK be permitted to vary its Charging Methodology Statement in a manner consistent with the terms of the proposed Charging Methodology. We have made this decision on the basis that we are satisfied that the proposed modifications meet the relevant Charging Methodology objectives,[3] as required under IUK's licence.[4] This decision should not be taken as implying a particular outcome in relation to our upcoming decision on IUK's application for a derogation from aspects of TAR, which will be taken separately based on the relevant criteria set out in TAR.

This letter contains a direction to approve the proposed modifications to IUK's Charging Methodology, and a direction permitting IUK to vary its Charging Methodology Statement in a manner consistent with the terms of the proposed Charging Methodology. It also explains the reasons for our decision as required under section 38A of the Gas Act 1986. As per the implementation timetable proposed by IUK, the changes to the Charging Methodology will take effect as of the start of the Gas Day on 5 March 2018.

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[1] Ofgem is the Office of the Gas and Electricity Markets Authority. The terms 'Ofgem', 'the Authority', 'we' and 'us' are used interchangeably in this letter.
[2] https://epr.ofgem.gov.uk/Document under 'Electronic Public Register/Licence Conditions/Standard Licence Conditions/Gas Interconnector/Current Version'.
[3] SLC 10(4) of the Licence.
[4] SLC 10(14) of the Licence.

Background

IUK is applying for approval of three proposals which relate to its ability to vary its prices in the short-term:

1. changes to its Charging Methodology
2. a direction under SLC10(15) that it may vary its prices consistent with the timetable in the proposed Charging Methodology, rather than the default 28 day notice period, and
3. a derogation from aspects of TAR for which the compliance date is 31 May 2019.

This decision deals with the first two of IUK's requests. IUK's application for a derogation from certain aspects of TAR will be dealt with in a separate decision according to the criteria established under TAR.

On 8 August 2017, IUK launched a consultation on its application for a derogation from certain aspects of TAR. At the same time, IUK consulted on proposed changes to its Charging Methodology. These changes included committing to publish a timetable for the publication of actual reserve prices.

Some responses to the consultation raised concerns about the degree of tariff flexibility available to IUK if we approved the proposals. In particular, a number of respondents were concerned that shippers would have insufficient certainty about the prices of shorter-term products to decide whether to purchase longer-term products at the annual capacity auctions.

IUK launched a second consultation on 25 October 2017 that included further changes to the Charging Methodology to address the concerns raised in the first consultation. The proposed changes in the second consultation included, amongst other changes, the introduction of a tariff setting and publication regime. The consultation was open for 28 days, as required under the licence.[5] A number of responses to the second consultation argued that the additional changes did not adequately address the concerns raised in the first consultation, and reiterated those concerns.

IUK submitted proposed changes to the Charging Methodology on 5 December 2017, alongside a request for a direction permitting IUK to vary its Charging Methodology Statement in a manner consistent with the terms of the proposed Charging Methodology. IUK also submitted an updated application for derogation from certain aspects of TAR. The final Charging Methodology proposal incorporated further changes taking into account the responses to the second consultation.

As required by the licence, IUK submitted the proposed changes alongside a report setting out the modifications as originally consulted on, any representations made by interested persons, the changes to the proposal as a consequence of the representations received and a timetable for the implementation of the modifications.[6] On 18 December 2017, IUK submitted an addendum to the report that included an explanation of how the proposed modifications better achieve the relevant objectives.[7] The Authority therefore considers that IUK has satisfied for 2017 the requirement to review the Charging Methodology each calendar year.[8]

As IUK operates in both Great Britain ('GB') and in Belgium, IUK simultaneously sought approval of the proposed modifications from both Ofgem and the Belgian energy regulator, the Commission for Electricity and Gas Regulation ('CREG').[9] Ofgem and CREG have

[5] SLC 10(11)(a)(i), (ii), (iii) and (v) of the Licence.
[6] SLC 10(11)(b) of the Licence.
[7] SLC 10(11)(a)(iv) of the Licence.
[8] SLC10(9) of the Licence.
[9] Also known as the Commissie voor de Regulering van de Elektriciteit en het Gas or the Commission de Régulation de l'Électricité et du Gaz, http://www.creg.be/en

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ensured frequent communication during the application process, and have both decided to approve the proposed changes to IUK's Charging Methodology.[10] However, we have undertaken an independent assessment of the proposed modifications as per our obligations under GB law.

Summary of the proposal

Caps on multipliers for capacity products with duration less than a year

The proposed Charging Methodology modification introduces caps on the maximum multiplier by which capacity products with a duration of less than a year can be more expensive than annual products.

Contract length	Quarterly	Monthly	Daily	Within-day
Maximum multiplier	1.5	3	6	6

These caps apply equally to reserve prices for auctions and for the price of any other capacity product approved by Ofgem and CREG.

Pricing publication timetable

The proposed Charging Methodology modification introduces a timetable for the publication of price information for the market. The modified Charging Methodology commits IUK to publishing actual prices for annual and quarterly products at least 30 days in advance of the annual CAM auction. At the same time, IUK is required to publish binding caps on the multipliers for monthly, daily and within-day products. This requirement applies equally to auction reserve prices, and to multipliers for standard duration implicit allocation products, if implicit allocation products were approved by Ofgem and CREG. Multipliers for non-standard duration implicit allocation products are required to fall within the cap of the shorter of the two standard duration products that the non-standard product's duration falls between.

Actual auction reserve prices are required to be published:

- two weeks ahead of each monthly auction for monthly products
- six hours ahead of each daily auction for daily products, and
- one hour ahead of each within-day auction for within-day products.

Actual prices for implicit allocation products longer than one month must be published at least one week in advance of being offered, and actual prices for implicit allocation products shorter than one month must be published at least a day in advance of being offered.

Other Charging Methodology changes

The proposed modification also includes changes to:

- Update various references to legislation.
- Simplify the document by removing unnecessary or out of date text.
- Ensure internal consistency of language, terms and units of measurement.
- Enable prices to be set for alternative allocation mechanisms if such mechanisms are approved by the Ofgem and CREG.
- Introduce a "risk premium" into the calculation of prices, as required by TAR.[11]
- Introduce references to the financial control framework recently established under Belgian law.[12]
- Allow differential pricing for different entry and exit points.

[10] CREG's decision is available at http://www.creg.be/fr/publications/decision-b14424
[11] Article 24 of TAR.
[12] CREG's financial control framework is available at http://www.creg.be/fr/publications/autres-z16541

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- Allow the buy-back premium for voluntary buy-back auctions, the initial registration fee, the monthly administration fee, and the commodity charge, to be set in the Charging Statement rather than the Charging Methodology.

Direction allowing variation of prices with less than 28 days notice

IUK also requested that we issue a direction under SLC10(15) allowing it to vary its prices in accordance with the pricing publication timetable set out in the proposed Charging Methodology.

Consultation responses

First consultation

There were twelve respondents to IUK's consultation in August, two of which were confidential. IUK has published the non-confidential responses on its website.[13] Five respondents did not comment on the Charging Methodology (IUK's consultation also covered separate changes to its Access Rules).

Of the respondents who did comment on the Charging Methodology, all were concerned that IUK's proposals did not oblige IUK to provide enough information to the market for shippers to assess the relative value of long and short-term capacity prior to auctions of annual capacity. Some of these responses argued that shippers could only make such assessments with complete certainty about the prices of each product before the auction of the annual products.

Second consultation

There were eight respondents to IUK's consultation in October, two of which were confidential. IUK has published the non-confidential responses on its website.[14]

The respondents argued that IUK's new proposals still did not provide enough information to the market for shippers to assess the relative value of long and short-term capacity prior to auctions of annual capacity. A number of respondents were still of the view that complete price certainty was needed for all products ahead of the auction for annual products.

Some respondents argued that it would be inappropriate for IUK to set prices taking into account price spreads and other market conditions. Arguments for why this would be inappropriate included that IUK might influence spreads between Belgium and GB, that uncertainty in prices could damage liquidity or cause shippers to seek alternative sources of supply, and that variable prices could unfairly increase the risk borne by shippers.

The Authority's decision

The Authority has reviewed the proposed modifications to IUK's Charging Methodology, taking into consideration the consultation responses and supporting evidence. We have decided to approve the proposed modifications to IUK's Charging Methodology and to issue a direction under SLC10(15) allowing IUK to vary its prices in accordance with the timetable included in the proposed Charging Methodology.

Our reason for our decision is that the proposed changes meet the relevant objectives for the Charging Methodology. That is, that the Charging Methodology be transparent, objective, non-discriminatory and compliant with the Regulation and any relevant legally

[13] Currently available at http://www.interconnector.com/about-us/our-consultations/latest-consultation/
[14] Currently available at http://www.interconnector.com/about-us/our-consultations/latest-consultation/

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binding decision of the European Commission and/or Agency. Ofgem has a duty to ensure proposed modifications meet these objectives.[15]

Having concluded that the proposed changes meet these licence objectives, it is our view that it is consistent with our statutory duties and the objectives of SLC10 to also issue a direction under SLC10(15) to allow IUK to vary its prices consistent with the pricing publication timetable established in the proposed Charging Methodology. As such, the period that the Charging Methodology Statement must be published prior to coming into effect will be:

- where a change to the Charging Methodology Statement is to an item included in the pricing publication timetable set out in the Charging Methodology, the relevant notice period in the pricing publication timetable, and
- where a change is to an item with no notice period specified in the pricing publication timetable, 28 days.

The detailed reasons for our decision are set out below.

Reasons for the decision

Transparency

The proposed Charging Methodology includes a price setting and disclosure regime. The proposal includes caps on the multipliers that IUK's short-term capacity prices can be in relation to the equivalent annual capacity. This restricts the possible prices for short-term capacity to a known range when IUK publishes annual capacity prices ahead of the annual capacity auction each year. The current Charging Methodology does not contain restrictions on multipliers.

Also included in the proposal is a pricing publication timetable setting out when IUK must publish binding caps and subsequently actual prices in relation to each product.

A number of respondents to IUK's two consultations noted that, under these proposals, shippers would not know the relative reserve prices of short-term capacity compared to annual capacity when auctions for annual capacity take place. Some of these respondents were of the view that, only by publishing binding relative reserve prices in advance of the annual auction, would shippers have sufficient information to decide whether to purchase annual capacity or shorter length products.

We do not agree that shippers require absolute certainty in the reserve price of short-term capacity ahead of the annual auction to decide whether to purchase long-term or short-term capacity. Individual shippers may balance the known cost of the long-term capacity against their appetite for accepting the risk of fluctuations in short-term capacity prices, within the bounds set out in IUK's proposed Charging Methodology.

A number of respondents to the consultations also expressed the view that it would be inappropriate for IUK, as a transmission system operator, to set short-term reserve prices in response to changes in market conditions. Arguments for this position included that IUK might influence market spreads, or that the increase in short-term price uncertainty might force shippers to seek alternative sources of supply.

IUK is a merchant asset that, in most current market conditions, competes with alternative providers of flexible gas supply (and demand). It is our view that, while competition and prevailing market conditions mean the risk of IUK being able to exert market power is limited, it is appropriate that IUK be able to vary prices in the short-term consistent with the price flexibility afforded under the proposed Charging Methodology.

[15] SLC 10(14) of the Licence.

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In relation to the increased risk for shippers, protection from the risk of short-term price changes is available in the form of long-term capacity bookings. Some respondents also argued that this risk might lead shippers to seek alternative sources of supply. We believe that it would not be appropriate for Ofgem to come to a view on whether IUK's proposed products and services would be attractive to its customers. Commercial considerations such as these are matters for IUK and its customers, especially given IUK's status as a merchant operator in a competitive market. We note that IUK has consulted twice, and both times made non-trivial changes to its proposal in response to the concerns raised by respondents.

Therefore, given the current market conditions, our view is that the arrangements proposed by IUK are sufficient to satisfy the licence objective that the Charging Methodology be transparent, as required by SLC10(4) and SLC10(14) of the Licence.

Compliance with Regulation (EC) No 715/2009 and any relevant legally binding decision of the European Commission

Article 24(b) of TAR sets out the formula that Transmission System Operators must use to set tariffs at an interconnection point if charging a fixed payable price, a requirement that came into force on 1 October 2017. This formula includes a risk premium. IUK offers a fixed payable price. Therefore, IUK is required under TAR to include a risk premium in its Charging Methodology; a requirement that they do not intend to request a derogation from.

IUK is proposing to include a risk premium as a factor in determining the reserve price for capacity.

The proposed Charging Methodology therefore brings IUK into compliance with a requirement of a relevant legally binding decision of the European Commission, as required by SLC10(4) and SLC10(14) of the Licence.

Objectivity and non-discrimination

We are of the view that IUK's proposed Charging Methodology remains objective and non-discriminatory. We note that no respondents to either of IUK's consultations expressed concerns in relation to whether IUK's proposed Charging Methodology was objective or non-discriminatory

Next steps

The proposed modifications to IUK's Charging Methodology will take effect as of the start of the Gas Day on 5 March 2018, as per the implementation timetable proposed by IUK.

We note, however, unless IUK receives a derogation from a number of requirements of TAR, that further changes to IUK's Charging Methodology are likely to be required for compliance purposes. We expect that, following our upcoming decision in relation to IUK's TAR derogation, IUK will assess the Charging Methodology for compliance with European Legislation generally, and TAR in particular, as part of the 2018 calendar year review of its Charging Methodology.

We also note that the appropriate level of transparency and charging flexibility for a transmission system operator is dependent, amongst other things, on both the competitive forces it faces, and its ability to exert market power. We expect IUK to keep the Charging Methodology under review to ensure it remains appropriate for actual and expected market conditions.

We expect that IUK's future reviews of the Charging Methodology will take into account the publication timetable set out in the version of the Charging Methodology approved by this decision. In particular, we would expect that reviews should allow for the National Regulatory Authorities to consider proposals for the three months established under the

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licence prior to the deadline for changes to be published 30 days in advance of the annual CAM auction.

Yours sincerely

Natasha Zoe Smith
Head of Gas Systems, Wholesale Markets

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ANNEX 1 – Charging Methodology

Direction issued to Interconnector (UK) Ltd pursuant to Standard Licence Condition 10 (Charging Methodology to apply to third party access to the licensee's interconnector) paragraph 14 of its Gas Interconnector Licence

1. This Direction is issued by the Gas and Electricity Markets Authority (the "Authority") pursuant to Standard Licence Condition 10 ("SLC 10") paragraph 14 of the gas interconnector licence ("the Licence") granted or treated as granted under section 7ZA of the Gas Act 1986 ("the Act") to Interconnector (UK) Ltd ("IUK" or "the licensee").

2. SLC 10 paragraph 9 requires the Licensee to review its Charging Methodology at least once in each calendar year and make such modifications to the Charging Methodology as may be requisite for the purpose of ensuring that the Charging Methodology better achieves the relevant Charging Methodology objectives. Following such a review and in accordance with SLC10 paragraph 11, on 5 December 2017, IUK submitted its proposed modified Charging Methodology to the Authority for approval.

3. SLC 10 paragraph 4 requires that the charges and application of the underlying Charging Methodology be objective, transparent, non-discriminatory and compliant with the Regulation (Regulation (EC) No 715/2009 on conditions for access to the national gas transmission networks) and any relevant legally binding decision of the European Commission and/or Agency (collectively the 'relevant Charging Methodology objectives').

4. Having regard to the relevant Charging Methodology objectives set out in SLC 10 paragraph 4, and to our principal objective and statutory duties, the Authority considers that IUK's proposed modified Charging Methodology meets the relevant Charging Methodology objectives.

5. The Authority hereby directs, pursuant to SLC 10 paragraph 14, that IUK's proposed modified Charging Methodology is approved.

6. This Direction shall come into effect at the beginning of the Gas Day on 5 March 2018, at which point the proposed Charging Methodology will replace the existing Charging Methodology. This Direction shall remain in effect until the Authority revokes or varies the Direction in writing upon reasonable notice.

7. This direction constitutes notice of the Authority's reasons for the decision pursuant to section 38A of the Act.

Dated: 28 February 2018

Natasha Zoe Smith
Head of Gas Systems, Wholesale Markets
Duly authorised on behalf of the Authority

The Office of Gas and Electricity Markets
9 Millbank London SW1P 3GE **Tel** 020 7901 7000 **Fax** 020 7901 7066 **www.ofgem.gov.uk**

ANNEX 2 – Charging Methodology Statement

Direction issued to Interconnector (UK) Ltd pursuant to Standard Licence Condition 10 (Charging Methodology to apply to third party access to the licensee's interconnector) paragraph 15 of its Gas Interconnector Licence

1. This Direction is issued by the Gas and Electricity Markets Authority (the "Authority") pursuant to Standard Licence Condition 10 ("SLC 10") paragraph 15 of the gas interconnector licence ("the Licence") granted or treated as granted under section 7ZA of the Gas Act 1986 ("the Act") to Interconnector (UK) Ltd ("IUK" or "the licensee").

2. SLC 10 paragraph 15 requires the Licensee to publish (at least on its website) a Charging Methodology statement that sets out the prevailing charges for access to the Licensee's interconnector and how the charges have been derived in accordance with its Charging Methodology. Unless the Authority directs otherwise, the Charging Methodology Statement must be published 28 days prior to it coming into effect.

3. On 5 December 2017, IUK submitted proposed changes to its Charging Methodology. IUK also requested that the Authority issue a direction under SLC 10 paragraph 15 to allow IUK to vary the Charging Methodology Statement in accordance with the pricing publication timetable established in the proposed Charging Methodology.

4. On 28 February 2018, the Authority approved IUK's proposed modified Charging Methodology. The Authority reached this decision having regard to our principal objective and statutory duties, on the basis that IUK's proposed modified Charging Methodology met the relevant Charging Methodology objectives.

5. Having approved IUK's proposed modified Charging Methodology, the Authority considers it is consistent with our principal objective and statutory duties to also direct, under SLC 10 paragraph 15, that IUK is not required to publish its Charging Methodology Statement 28 days prior to it coming into effect. We instead consider it appropriate that IUK publish the Charging Methodology Statement consistent with the notice periods established under the pricing publication timetable in the Charging Methodology.

6. The Authority hereby directs that, pursuant to SLC 10 paragraph 15, the requirement that the Charging Methodology Statement be published 28 day prior to coming into effect be waived. The Authority instead directs that the period that the Charging Methodology Statement must be published prior to coming into effect is the relevant notice period in the pricing publication timetable set out in the Charging Methodology, where the change is to an item in the pricing publication timetable, and 28 days in all other cases.

7. This Direction shall come into effect at the beginning of the Gas Day on 5 March 2018. This Direction shall remain in effect until the Authority revokes or varies the Direction in writing upon reasonable notice.

8. This direction constitutes notice of the Authority's reasons for the decision pursuant to section 38A of the Act.

Dated: 28 February 2018

Natasha Zoe Smith
Head of Gas Systems, Wholesale Markets
Duly authorised on behalf of the Authority

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