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CC. Marie-Pierre Fauconnier,
President of the Commission for Electricity and
Gas Regulation, Belgium

Date: 17 July 2018

Dear Pavanjit

Authority decision to derogate Interconnector (UK) from certain articles of Commission Regulation (EU) 2017/460

Summary

On the 5 December 2017, Interconnector UK (IUK) submitted an application for derogation from a number of articles of Commission Regulation (EU) 2017/460 establishing a network code on harmonised transmission tariff structures for gas ('TAR')¹ to Ofgem for review, pursuant to Article 37 of TAR. This letter outlines our decision granting IUK derogation from certain articles of TAR and our reasons for doing so in line with the criteria in Article 37.

Background

TAR came into force on 5 April 2017. TAR aims to contribute to European market integration, enhance security of supply and promote interconnection between gas markets. It does this by introducing a number of requirements for transmission system operators (TSOs).² In particular, it sets out how TSOs must design reference price methodologies³ and how corresponding reserve prices are calculated. There are also requirements in TAR that aim to increase the transparency of tariffs. These relate to requirements to publish and consult on various pieces of information.

TAR recognises that its requirements could jeopardise the efficient operation of some interconnectors. Accordingly, Article 37 of TAR states that National Regulatory Authorities (NRAs) may, at the request of an entity which operates an interconnector and has benefited from certain exemptions⁴, grant a derogation from one or more articles in TAR. NRAs may grant a derogation if the application of those particular articles would have one or several of the following negative consequences:

- a. not facilitate efficient gas trade and competition;

¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0460&from=EN>.

² Note that interconnectors are considered to be TSOs and are certified as TSOs.

³ TAR defines reference price methodology as the methodology applied to the part of the transmission services revenue to be recovered from capacity-based transmission tariffs with the aim of deriving reference prices.

⁴ To be eligible for a derogation, an interconnector must have benefited from an exemption from Article 41(6), (8) and (10) of Directive 2009/73/EC in accordance with Article 36 of that Directive or a similar exemption.

- b. not provide incentives for investment for new capacity or to maintain existing levels of capacity;
- c. unreasonably distort cross-border trade;
- d. distort competition with other infrastructure operators that offer services of a similar nature to those of the interconnector;
- e. not be implementable when taking into account the specific nature of interconnectors.

On the 5 December 2017, IUK submitted an application for derogation from certain articles of TAR to Ofgem for review. At the same time, IUK submitted proposed changes to its Charging Methodology⁵. The proposed Charging Methodology aims to facilitate compliance with TAR, excluding the requirements in TAR from which IUK is seeking derogation. The final deadline for TAR implementation is 31 May 2019.

We approved changes to IUK's charging methodology in a separate decision on 28 February 2018.⁶ Our views on IUK's charging methodology did not imply any position on IUK's derogation application.

IUK's proposal

IUK's overarching reason for applying for derogation from certain articles of TAR is that it is a merchant asset without a regulated allowed revenue. In its application, IUK noted it relies exclusively on market demand and capacity bookings for its revenues, and competes in the market with other flexibility assets such as storage and LNG. As such, IUK's view is that a derogation from certain aspects of TAR is necessary for its ongoing business viability and to ensure it can compete in the market with other flexibility sources.

In particular, IUK argues that derogation is required for the following three categories of articles:

- 1) articles that restrict tariff flexibility and IUK's ability to compete in the market
- 2) articles that require the publication of information that is commercially sensitive for IUK as a merchant interconnector
- 3) articles that relate to TSOs with a regulated asset base, captive customers and multiple network points and are therefore not relevant to IUK as a merchant interconnector.

The table in **Appendix 1** summarises which parts of TAR IUK is seeking derogation from and, in IUK's view, which of the negative consequences listed in Article 37 each article would cause if applied. IUK's arguments for each category of articles has also been summarised below.

Articles that restrict tariff setting flexibility

Applicable articles: 12.3, 13, 28, 29(a), 29(b)(i), 31.2(a)

In its application, IUK argues it needs greater flexibility than the above articles provide, to set its tariffs as it is a merchant asset that competes with other sources of gas flexibility.

Article 12.3 requires that reserve prices for quarterly, monthly, daily and within day capacity are set in advance of the relevant gas year and fixed throughout that gas year. Article 13 requires that multipliers and seasonal factors, which are applied to the reference price, to calculate the reserve price of non-yearly capacity products, must be set within a

⁶https://www.ofgem.gov.uk/system/files/docs/2018/02/decision_letter_on_proposed_modifications_to_iuk_charging_methodology.pdf

certain range. Article 28, Article 29(a) Article 29(b)(i) and Article 31.2(a) require the publication of information relating to the above articles.

IUK argues that these articles would not enable it to react to changing market conditions, and provide constraints that are not applied to its competitors.

Articles that would expose commercially sensitive information

Applicable articles: 7(a), 26.1(a)(iii), 26.2, 30.1(b)(ii), 30.1(b)(iii)(2,3,5)

IUK argue that the application of these articles would force IUK to release commercially sensitive information to its competitors.

Article 7(a) of TAR requires TSOs to choose a reference price methodology that enables network users to reproduce the calculation of reference prices and their accurate forecast. Under Article 26 of TAR, GB interconnectors⁷ must consult periodically on charging information prior to charges coming into effect. This includes the indicative reference price as required by 26.1(a)(iii). Article 26.2 also requires that the final consultation should be open for two months. IUK argue that these articles would reveal its pricing strategy, which in IUK's view is commercially sensitive information.

In addition, Article 30.1(b)(i),(ii) and (iii) includes information that TSOs must publish before the tariff period, including target revenue and capital and operating expenditures. IUK argue that this is commercially sensitive information and its publication would give an unfair advantage to its competitors.

Articles not relevant to merchant interconnectors

Applicable articles: 5, 26.1(a)(vi), 30.1(a)(ii)(iii), 30.1(b)(i)(ii), 30.1(b)(iii)(1), 30.1(b)(iv)(v), 30.2,

IUK noted in its application that these articles relate to TSOs with a regulated asset base, captive customers and multiple network points and therefore would not be relevant to IUK as a merchant interconnector.

Article 5 of TAR requires TSOs to perform cost allocation assessments, in order to identify the level of cross subsidisation between cross-system and intra-system network users⁸. IUK notes that it does not have domestic points or a transmission services revenue necessary to perform a cost allocation assessment, and as a result applying the formula does not provide meaningful information.

Article 26.1(a)(vi) of TAR requires TSOs to consult on a comparison of a proposed reference price methodology compared to an equivalent methodology using capacity weighted distance. IUK argue the capacity weighted distance approach is suited to a TSO with multiple network points and a regulated asset base, meaning a comparison would not be practical or generate valuable results.

The other articles relating to Article 30 mentioned above are also applicable to TSOs with a regulated asset base and transmission services revenue, which IUK do not consider relevant, as they do not have either.

⁷This requirement can fall on either the TSO or NRA as decided by the NRA. In the case of interconnectors, we decided that the TSO should do this task.

https://www.ofgem.gov.uk/system/files/docs/2017/10/ofgem_tar_assignment_of_tasks_decision_003.pdf

⁸ TAR defines cross-system network users as those transporting gas within the entry exit system to customers in a different entry exit system, and Intra-system network users as those transporting gas within the entry exit system to customers within another entry exit system.

Articles withdrawn from application

In its application, IUK requested derogation from Articles 30.1(b)(iii)(3)(a),(c),(d) and 30.1(b)(iii)(4). IUK subsequently informed us that it will not be seeking derogation from these articles. We therefore do not consider these articles further in this decision and IUK must ensure that it complies with Articles 30.1(b)(iii)(3)(a),(c),(d) and 30.1(b)(iii)(4).

Industry Consultation

First consultation

On 8 August 2017, IUK ran an initial consultation on both its derogation application and amendments to its Charging Methodology. For the avoidance of doubt, where a respondent commented on aspects of the Charging Methodology that relate to the articles in TAR from which IUK has sought derogation, we considered these also in respect to IUK's derogation application.

There were twelve responses to IUK's consultation in August, two of which were confidential. IUK has published the non-confidential responses on its website.⁹ Five respondents did not comment on the derogation application or the aspects of TAR that IUK are seeking derogation from.

Of the respondents who did comment on the derogation application and relevant Charging Methodology changes, many were concerned that the proposals gave IUK too much freedom in its price setting.

Second consultation

In order to address the concerns raised by industry, IUK launched a second consultation on 25 October 2017. In its second consultation, IUK did not propose to amend its derogation application but proposed a new amended charging methodology that, among other changes, proposed to put absolute caps on short-term multipliers.

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.¹⁰

Some respondents argued that IUK's new proposals still did not provide enough information to the market. A number of respondents were of the view that complete price certainty was still needed for all products ahead of the auction for annual products, in line with TAR requirements.

The Authority's decision

Eligibility for derogation

Article 37 stipulates that derogations may be granted at the request of an interconnector operator that has benefited from an exemption from Article 41(6), (8) and (10) of Directive 2009/73/EC, or a similar exemption. IUK does not hold an exemption under Directive 2009/73/EC as its construction predates this legislation. Instead, IUK received a letter of comfort from the European Commission in 1995 that exempted it from certain restrictions under Article 85(1) of the Treaty Establishing the European Community (the Treaty).¹¹

We have reviewed the arguments put forward by IUK in relation to its eligibility. Given the similarities in the criteria between Article 85(1) of the Treaty and the relevant articles of

⁹ <http://www.interconnector.com/about-us/our-consultations/latest-consultation/>

¹⁰ <http://www.interconnector.com/about-us/our-consultations/latest-consultation/>

¹¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:11992E/TXT> - (consolidation in force in 1995)

Directive 2009/73/EC, we agree that IUK does have a sufficiently similar exemption to the exemption referenced in Article 37 of TAR in order to be eligible to apply for derogation.

Our Decision

Following consideration of IUK's derogation application and the responses to IUK's consultations, and having regard to the Authority's principal objective and statutory duties, we have decided to grant IUK derogation from the articles listed in **Appendix 2**. This excludes the articles that IUK withdrew from its application.

In reaching our decision we have liaised with the Belgian NRA, the Commission for Electricity and Gas Regulation (CREG), to ensure we have made consistent regulatory decisions.¹²

Reasons for our decision

IUK is a merchant asset that, in most current market conditions, competes with alternative providers of flexible gas supply (and demand).

Taking into consideration this competitive environment, it is our view that the application of some articles that restrict IUK's tariff setting flexibility and the application of articles that would force IUK to reveal commercially sensitive information will distort competition with other infrastructure operators that offer services of a similar nature¹³.

Furthermore, it is our view that some articles in TAR that relate to TSOs with a regulated asset base, captive customers and multiple network points are not implementable given the specific nature of IUK as a merchant interconnector.¹⁴

Articles that restrict tariff flexibility and IUK's ability to compete in the market

We agree that Article 12.3 and Article 13 would inhibit IUK's ability to optimise the price of its short-term products and therefore we consider that the application of these articles would distort competition with other operators that offer services of similar nature to IUK. Given the competitive environment, we think it is appropriate for IUK, as a merchant interconnector operator, to have more tariff setting flexibility than allowed for under TAR.

The same considerations can be made in relation to Articles 28, 29(a) and 29(b) that require IUK to publish and consult on information related to the specific tariff setting process in TAR.

With regards to the responses to IUK's consultations, 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.

For the above reasons, we derogate IUK from the following articles in TAR: 12.3, 13, 28, 29(a), 29(b)(i), 31.2(a).

We note that IUK's tariff setting regime is set out in its Charging Methodology. We approve any changes to the Charging Methodology under Standard Licence Condition (SLC) 10 of the gas interconnector licence. Although IUK is derogated from the requirements of TAR for the articles listed above, IUK will continue to review its Charging Methodology annually and must ensure it meets the relevant Charging Methodology objectives. That is, that the Charging Methodology be transparent, objective, non-discriminatory and compliant with the

¹² Article 37(3)

¹³ TAR Article 37, criteria (d)

¹⁴ TAR Article 37, criteria (e)

Regulation¹⁵ and any relevant legally binding decision of the European Commission and/or Agency.

Articles that require the publication of information that is commercially sensitive for IUK as a merchant interconnector.

We also consider that where TAR requires the publication of information that is commercially sensitive for IUK as a merchant interconnector operator, the application of such articles will distort competition. Articles 7(a), 26.1(a)(iii) and 26.2 would require IUK to reveal its pricing strategy, while 30.1(b)(ii), 30.1(b)(iii)(2),(3)(b),(5) would reveal sensitive information relating to its commercial operation. We agree with IUK that these articles would require IUK to publish information that is commercially sensitive and in doing so would distort competition with other operators that offer services of a similar nature.

For the above reasons, we derogate IUK from the following articles in TAR: 7(a), 26.1(a)(iii), 26.2, 30.1(b)(ii), 30.1(b)(iii),(2),(3)(b),(5).

Articles that relate to TSOs with a regulated asset base, captive customers and multiple network points and are therefore not relevant to IUK as a merchant interconnector

We also consider that certain articles in TAR are not implementable for IUK as a merchant interconnector. Articles 5, 26(a)(vi), 30.1(a)(ii)(iii), 30.1(b)(i)(ii), 30.1(b)(iii)(1), 30.1(b)(iv)(v), and 30.2 relate to TSOs with a regulated asset base, captive customers and multiple network points. IUK does not have these characteristics. We therefore agree that these articles would not be implementable when taking in to account the specific nature of IUK as a merchant interconnector.¹⁶

For above reasons, we derogate IUK from the following articles in TAR: 5, 26.1(a)(vi), 30.1(a)(ii)(iii), 30.1(b)(i)(ii), 30.1(b)(iii)(1), 30.1(b)(iv)(v), 30.2.

Next steps

Our decision to derogate IUK from the articles in TAR listed above is effective immediately and those articles are hereby suspended from effect.

As outlined in Article 37 of TAR, we may revoke any or all of the derogations granted in this letter if the circumstances or underlying reasons, or both, no longer apply or upon a reasoned recommendation of the Agency for Cooperation of Energy Regulators (ACER) or the Commission to revoke a derogation.¹⁷

The above derogations shall continue until the Authority decides to revoke the derogations granted. IUK must notify us in the event of any material changes to circumstances relating to its derogation application. In addition, IUK shall provide the Authority with an annual report by 31 December 2019 and then each calendar year thereafter. The report must outline whether the derogations granted are suitable and necessary in preventing the negative consequences listed in Article 37.

We will be notifying this decision to the ACER and the European Commission.¹⁸

If you have any questions relating to this decision, please contact Robin.Dunne@Ofgem.gov.uk.

¹⁵ Regulation (EC) No 715/2009 on conditions for access to the natural gas transmission networks <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32009R0715>

¹⁶ TAR Article 37, criteria (e)

¹⁷ Article 37(5)

¹⁸ Article 37(4)

Yours sincerely

Mark Copley

Deputy Director, Wholesale Markets
Duly authorised on behalf of the Authority

Appendix 1 – Summary of Requested Derogations

The below table summarises which parts of TAR IUK is seeking derogation from and, in IUK's view, which of the negative consequences listed in Article 37 each article would cause if applied.

Chapter	Description	Articles Applied for derogation¹⁹	Criteria Article 37 (a-e)
I – General Provisions	Cost Allocation Assessments	5 (entire article)	(a),(e)
	Choice of a reference Price Methodology	7 (a)	(d),(e)
II – Reference Price Methodologies	General Provisions	12.3	(a),(b),(c),(d),(e)
III – Reserve Prices	Level of Multipliers and Seasonality factors	13 (entire article)	(a),(b),(c),(d),(e)
VII – Consultation Requirements	Periodic Consultation	26.1(a)(iii),(vi) and 26.2	(a),(b),(c),(d),(e)
	Consultation on discounts, multipliers and seasonal factors	28 (entire article)	(a),(b),(c),(d),(e)
VIII – Publication Requirements	Information to be published before the annual yearly capacity auction	29(a) and (b)(i)	(a),(b),(c),(d),(e)
	Information to be published before the tariff period	30.1(a)(ii) and (iii), 30.1(b)(i) and (ii), 30.1(b)(iii)(1) 30.1(b)(iii),(2),(3)(b),(5) 30.1(b)(iv) and (v) 30.2	(a),(b),(c),(d),(e)
	Form of Publication	31.2(a)	(a),(b),(c),(d),(e)

¹⁹ In its application, IUK also requested derogation from Articles 30.1(b)(iii)(3)(a),(c),(d) and 30.1(b)(iii)(4). IUK subsequently informed us that it will not be seeking derogation from these articles, which are therefore not included in this table.

Appendix 2 – Summary of Granted Derogations

The below table summarises which parts of TAR we have granted IUK derogation from.

Chapter	Description	Articles from which IUK have been granted Derogation	Criteria Article 37 (a-e)
I – General Provisions	Cost Allocation Assessments	5 (entire article)	(e)
	Choice of a reference Price Methodology	7 (a)	(d)
II – Reference Price Methodologies	General Provisions	12.3	(d)
III – Reserve Prices	Level of Multipliers and Seasonality factors	13 (entire article)	(d)
VII – Consultation Requirements	Periodic Consultation	26.1(a)(iii), 26.1(a)(vi) 26.2	(d) (e) (d)
	Consultation on discounts, multipliers and seasonal factors	28 (entire article)	(d)
VIII – Publication Requirements	Information to be published before the annual yearly capacity auction	29(a) and 29(b)(i)	(d)
	Information to be published before the tariff period	30.1(a)(ii) and (iii), 30.1(b)(i) and (ii), 30.1(b)(iii)(1) 30.1(b)(iii),(2),(3)(b),(5) 30.1(b)(iv) and (v) 30.2	(e) (e) (e) (d) (e) (e)
	Form of Publication	31.2(a)	(d)