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

Date: 6 February 2017

Dear Sean

**Authority decision not to approve proposed modifications to
Interconnector (UK)'s charging methodology and access rules**

On 2 December 2016, Interconnector (UK) ('IUK') proposed modifications to its charging methodology and access rules to the Authority¹ for approval, pursuant to Standard Licence Conditions ('SLCs') 10 and 11A of the gas interconnector licence ('licence').² These changes relate to the provision of two new services; a 'Re-Profiling Service' and a 'Simplification Conversion Service'.

After careful consideration, we have decided not to approve the proposed modifications to IUK's charging methodology and access rules. We have made this decision on the basis that we are not satisfied that the proposed modifications meet the relevant charging methodology objectives³ and access rules objectives⁴, as required under IUK's licence⁵.

In particular, we are not satisfied the proposals meet the objective that the charging methodology and access rules be "compliant with the Regulation⁶ and any relevant legally binding decision of the European Commission and/or Agency". The proposals are not compliant with Commission Regulation (EU) No 984/2013 establishing a Network Code on Capacity Allocation Mechanisms in Gas Transmission Systems⁷ ('CAM'). CAM was adopted on the basis of Regulation (EC) No 715/2009⁸ ('the Regulation') which it supplements and of which it forms an integral part.⁹

This letter contains two directions: one to not approve the proposed modifications to IUK's charging methodology and one to not approve the proposed modifications to IUK's access

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).

⁴ SLC 11A(5).

⁵ SLC 10(14) and SLC 11A(14).

⁶ Where we refer to "the Regulation" we mean Regulation (EC) No 715/2009.

⁷ <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32013R0984>.

⁸ <http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:32009R0715>.

⁹ Recital (6) of CAM.

rules. It also explains the reasons for our decision as required under section 38A of the Gas Act 1986.

Background

IUK is a certified Transmission System Operator (TSO) and holder of a gas interconnector licence. It operates a gas interconnector through which gas flows in both directions between the UK and continental European energy markets via Belgium.

On 13 October 2016 IUK launched a consultation on the introduction of modifications to its charging methodology and access rules to enable it to offer two new services, a 'Re-Profiling Service' and a 'Simplification Conversion Service'.

The Re-Profiling Service

IUK propose to offer a service whereby shippers can release a portion of annual IUK capacity that they hold back to IUK, subject to certain limitations. The shipper would not be obliged to pay for capacity returned to IUK in this manner, and the capacity would be made available to the market by IUK at the next auction.

IUK's indicative¹⁰ limitations include that:

- in no month can re-profiled capacity exceed the peak monthly capacity purchased
- the shipper must retain at least three months at this peak monthly capacity, and
- the shipper has the right to return up to 50% of the total capacity booked.

IUK would charge a separate fee, in addition to the price of capacity, for the use of the Re-Profiling Service (with reserve prices for annual capacity unchanged by the introduction of the Re-Profiling Service).

The Simplification Conversion Service

IUK propose to offer a 'Simplification Conversion Service' where a shipper holding capacity at one of IUK's two interconnection points could pay a fee to have equivalent rights to flow gas at the other IUK interconnection point. A shipper could then nominate gas flows at one interconnection point and have this nomination treated as a nomination for flows of gas at the other interconnection point as well.

IUK's submission, consultation and compliance

As required by the licence, IUK held a four week consultation period,¹¹ closing on 10 November 2016. During this period IUK also held an industry workshop to explain the proposals. IUK published the non-confidential representations shortly after the consultation on its website.¹²

On 2 December 2016, when submitting the proposed modifications for approval, IUK provided a report pursuant to SLC 10(11)(b) and SLC 11A(11)(b) of their licence. The report sets out the modifications as originally consulted on, any representations made by interested persons, the changes to the terms of the modifications as a consequence of the representations received, how the proposed modifications better achieve the relevant objectives and a timetable for the implementation of the modifications.

¹⁰ IUK's submission left the parameters of the limitations subject to finalisation, these limitations are therefore based on the proposals in IUK's consultation documentation.

¹¹ SLC 10(11)(a) and SLC 11A(11)(a) for the respective charging methodology and access rules requirements.

¹² <http://www.interconnector.com/about-us/our-consultations/archived-consultations/>

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 Commissie voor de Regulering van de Elektriciteit en het Gas ('CREG'). While all three parties (IUK, Ofgem and CREG) have ensured frequent communication during the application process, Ofgem has undertaken an independent assessment of the proposed modifications as per the obligations of IUK and Ofgem under the current law in GB.

The Authority's decision

The Authority has reviewed the proposed modifications to IUK's charging methodology and access rules, taking into consideration the consultation responses and supporting evidence. Following this process, we have decided not to approve the proposed modifications to IUK's charging methodology and access rules.

Our reason for not approving the proposals is that they do not meet the relevant objectives for the charging methodology and the access rules. Under the SLCs Ofgem has duties to ensure proposed modifications meet these objectives.

The proposals fail to meet the objective that proposed modifications to the charging methodology and access rules be "compliant with the Regulation and any relevant legally binding decision of the European Commission and/or Agency". In particular, the proposals are not compliant with CAM, which was adopted on the basis of the Regulation which it supplements and of which it forms an integral part.¹³

CAM aims to facilitate equal and transparent access to transmission capacity, achieve effective competition on the wholesale gas market and facilitate a more transparent, efficient and non-discriminatory system of capacity allocation. CAM aims to achieve this by (amongst other things):

- requiring auctions of capacity
- requiring bundling of capacity products at interconnection points (IPs) where possible, and
- introducing standard-duration capacity products and establishing an order in which they are to be offered.

The Re-Profiling Service (and the Simplification Conversion Service when combined with the Re-Profiling Service) facilitates the allocation of monthly and quarterly capacity products out of sequence with annual products, in breach of Articles 8(3), 12 and 13.

The Simplification Conversion Service is in breach of CAM as it:

- allocates capacity other than by the required auction process, in breach of Articles 8(1), 11(2) and (when combined with Re-Profiling Service) 12(2) and 13(2) of CAM, and
- enables the offer of unbundled capacity in a manner which breaches Articles 19(1) and 19(5) of CAM.

As a result of these breaches, the Re-Profiling Service and the Simplification Conversion Service also breach Article 19(2) of CAM which requires capacity be offered in accordance with the requirements of Chapter III of CAM (Articles 8 to 17).

We have set out our reasons for these conclusions below.

¹³ Recital (6) of CAM

Reasons for the decision

Preliminary Questions

Before the question of compliance can be dealt with, we consider some preliminary questions on the scope of CAM and the nature of the Simplification Conversion Service.

Scope of CAM

The relevant requirements of CAM apply to both the Re-Profiling Service and Simplification Conversion Service.

In the report and supporting documentation describing the proposals, IUK argue that CAM establishes a minimum set of products to be offered by TSOs rather than the entirety of products that may be offered. IUK further consider that CAM envisages TSOs offering products above and beyond the minimum specified in CAM.

Even if IUK is correct, and CAM does not prohibit the introduction of new products, new products must still comply with CAM. That is, new products must comply with any articles of CAM that are relevant to that product. For instance, if a product meets the definition of “capacity” then any article of CAM that applies to “capacity”, applies to that product.

Allocation of capacity via the Simplification Conversion Service

The Simplification Conversion Service allocates capacity.

CAM does not define the term ‘capacity’, however CAM supplements Regulation 715/2009 and should be read as consistent with it. Article 2 of Regulation 715/2009 states that:

‘capacity’ means the maximum flow, expressed in normal cubic meters per time unit or in energy unit per time unit, to which the network user is entitled in accordance with the provisions of the transport contract.

For users who already have the right to flow gas under a transport contract at one interconnection point, the Simplification Conversion Service entitles the user to flow the same quantity of gas at the other interconnection point. This is an entitlement to flow gas at a point the user did not previously have such an entitlement, which meets the definition of capacity. Furthermore, the purchase of the Simplification Conversion Service results in a reduction in the capacity available at future auctions at the interconnection point where the shipper has acquired rights to flow gas, as happens when capacity is allocated.

IUK’s proposal and supporting documentation argues that the Simplification Conversion Service does not allocate capacity. Instead IUK states that the Simplification Conversion Service only converts capacity already purchased by a shipper from being the capacity at a single interconnection point (‘IP’) in a two interconnection point system (‘2-IP’) to being equivalent to capacity in a single interconnection point system (‘1-IP’). According to IUK this 1-IP equivalent capacity is therefore allocated at the original purchase of capacity (albeit not originally as 1-IP equivalent capacity), not when the Simplification Conversion Service was purchased.

However, in order to use the Simplification Conversion Service a separate fee must be paid, indicating the entry into of a collateral contract to obtain additional rights in consideration for an additional fee. This shows that the capacity rights at the second interconnection point were allocated by the purchase of the Simplification Conversion Service purchased, not by the initial purchase of capacity at the first interconnection point. The Simplification Conversion Service therefore allocates capacity.

Areas of non-compliance

The following sections explain where the proposals are in breach of CAM.

Sequencing of auctions under CAM

The Re-Profiling Service (and the Simplification Conversion Service when combined with the Re-Profiling Service) breaches the CAM requirement for yearly, quarterly and monthly capacity products to be offered sequentially.

Article 8(3) of CAM states that:

The standard capacity products shall follow a logical order by which products covering yearly capacity shall be offered first, followed by the product with the next shortest capacity duration for use during the same period. The timing of the auctions provided for in Articles 11 to 15 shall be consistent with this principle.

CAM then establishes the procedures and timing of auctions for yearly standard capacity products (once annually no longer than 15 years in advance)¹⁴, quarterly standard capacity products (once annually for the four quarters of the upcoming gas year)¹⁵ and monthly standard capacity products (once monthly for the following calendar month)¹⁶.

IUK argue that only 'standard' capacity products need to comply with these requirements, and that products with 'non-standard' terms and conditions need not comply with those requirements. IUK consider that the Re-Profiling Service and Simplification Conversion Service are not standard capacity products. However, Article 2 of CAM states that:

'standard capacity product' means a certain amount of transport capacity over a given period of time, at a specified interconnection point.

Both the Re-Profiling Service and the Simplification Conversion Service result in the allocation of 'a certain amount of transport capacity over a given period of time, at a specified interconnection point' and therefore satisfy the definition of a 'standard capacity product'. The requirements of Articles 8 and 11 to 15 therefore apply to both the Re-Profiling Service and the Simplification Conversion Service.

Under IUK's proposal a shipper holding annual capacity will be able to use the Re-Profiling Service to alter their capacity holdings such that the capacity will not be in *a given amount for all gas days in a particular gas year* and therefore will no longer satisfy the definition of a yearly standard capacity product.¹⁷ However, the capacity will be in *a given amount for all gas days in a particular month* for each month in the calendar year, and possibly (depending on the profile chosen by the shipper) *in a given amount for all gas days in a particular quarter*. That is, the shipper will then hold capacity satisfying the definition of a monthly standard capacity product (or possibly a quarterly standard capacity product) for each month (or quarter) of the gas year in question.¹⁸

The Re-Profiling Service therefore enables the offer of quarterly and monthly standard capacity products prior to when the annual standard capacity products for that gas year have been offered for the final time. Similarly, when combined with the Re-Profiling Service, the Simplification Conversion Service would enable the offer of quarterly and monthly standard capacity products prior to when the annual standard capacity products for that gas year have been offered for the final time.

¹⁴ Article 11 of CAM.

¹⁵ Article 12 of CAM.

¹⁶ Article 13 of CAM.

¹⁷ Article 9(2) of CAM.

¹⁸ Articles 9(3) and 9(4) of CAM.

The Re-Profiling Service and Simplification Conversion Service therefore breach the requirements of Articles 8(3) and 12 to 13 of CAM.

CAM requirement for capacity to be auctioned

The Simplification Conversion Service breaches the CAM requirement for capacity to be auctioned.

Article 8(1) of CAM states:

Auctions shall be used for the allocation of capacity at interconnection points.

This requirement is clearly phrased to apply to any product or service through which capacity is allocated, not just the set of products described elsewhere in CAM. Since the Simplification Conversion Service allocates capacity, and it does so through a fixed fee and not through an auction, it is in breach of Article 8(1) of CAM.

In addition, the Simplification Conversion Service breaches the requirement in Article 11(2) of CAM that “yearly standard capacity products must be auctioned using an ascending-clock auction algorithm in accordance with article 17”. Similarly, when combined with the Re-Profiling Service, the Simplification Conversion Service breaches the equivalent requirement for quarterly (Article 12(2)) and monthly (Article 13(2)) standard capacity products.

CAM requirement for capacity to be bundled

The Simplification Conversion Service breaches the CAM requirement for capacity to be bundled.

Article 19 of CAM states that:

Adjacent transmission system operators shall jointly offer bundled capacity products, according to the following principles:

- (1) On both sides of an interconnection point all firm capacity shall be offered as bundled capacity, in so far as there is available firm capacity on both sides of the interconnection point...”

IUK argue that once the capacity in question has been offered as bundled capacity on one occasion, the requirements of Article 19 have been satisfied, and firm capacity can be offered again (and allocated) as unbundled capacity as per the Simplification Conversion Service.

However, there is no indication in the wording of Article 19 that firm capacity does not need to be offered as bundled capacity every time an offer for firm capacity is made (provided firm capacity is available on both sides of the interconnection point). If CAM only required that capacity be offered as bundled once, the bundling requirement would no longer be effective in most cases. For example, under IUK’s proposed interpretation, annual capacity for 2035 would only need to be offered as bundled in the 2020 auction, but could be offered as unbundled in every subsequent auction of annual capacity for 2035.

As discussed above, the Simplification Conversion Service allocates capacity on the IUK side of an interconnection point. However, the Simplification Conversion Service does not allocate the equivalent capacity from the adjacent TSO at that interconnection point. For example, a shipper holding IUK entry capacity at the Zeebrugge interconnection point who then uses the Simplification Conversion Service, would be allocated IUK exit capacity at the

Bacton interconnection point, but not National Grid Gas ('NGG') entry capacity at the Bacton interconnection point.

The Simplification Conversion Service therefore enables the allocation of unbundled capacity without offering this as a bundled product when firm capacity is available on both sides of an interconnection point. The Simplification Conversion Service therefore breaches Article 19(1) of CAM.

In addition, the Simplification Conversion Service breaches the requirements of Article 19(5) of CAM by offering unbundled capacity outside of the specified allowed circumstances.

Next steps

As a result of our decision, the versions of IUK's access rules and charging methodology that are currently in place will remain unchanged. IUK remain entitled to submit alternative proposals for modifications to IUK's access rules and charging methodology subject to the SLCs, which the Authority will consider as necessary.

Yours sincerely

Emma Kelso

Partner, Wholesale Markets

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 2 and 11, on 2 December 2016 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 do not meet the relevant charging methodology objectives. In particular, the Authority considers that the proposed modified access rules are not compliant with Regulation (EC) No 715/2009 and any relevant legally binding decision of the European Commission and/or Agency.
5. The Authority hereby directs, pursuant to SLC 10 paragraph 14, that IUK's proposed modified charging methodology is not approved and the charging methodology last approved by the Authority on 30 July 2015 remains in place.
6. This Direction shall have immediate effect. It shall remain in effect until such time as the Authority may revoke or vary 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: 6 February 2017

Emma Kelso

Partner, Wholesale Markets

Duly authorised on behalf of the Authority

ANNEX 2 – Access Rules

Direction issued to Interconnector (UK) Ltd pursuant to Standard Licence Condition 11A (approval of terms for 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 11A (SLC 11A) 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 11A paragraph 9 requires the licensee to review its Access Rules at least once in each calendar year and make such modifications to the Access Rules as may be requisite for the purpose of ensuring that the Access Rules better achieve the relevant access rules objectives. Following such a review and in accordance with SLC 11A paragraphs 2 and 11, on 2 December 2016 IUK submitted its proposed modified Access Rules to the Authority for approval.
3. SLC 11A paragraph 5 requires that the Access Rules be transparent, objective, 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 access rules objectives').
4. Having regard to the relevant access rules objectives set out in SLC 11A paragraph 5, and to our principal objective and statutory duties, the Authority considers that IUK's proposed modified access rules do not meet the relevant access rules objectives. In particular, the Authority considers that the proposed modified access rules are not compliant with Regulation (EC) No 715/2009 and any relevant legally binding decision of the European Commission and/or Agency.
5. The Authority hereby directs, pursuant to SLC 11A paragraph 14, that IUK's proposed modified Access Rules are not approved and the Access Rules last approved by the Authority on 21 September 2015 remain in place.
6. This Direction shall have immediate effect. It shall remain in effect until such time as the Authority may revoke or vary 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: 6 February 2017

Emma Kelso

Partner, Wholesale Markets

Duly authorised on behalf of the Authority