European Regulation
Centrica

9th May 2008

To: ERGEG
By email: article22@ergeg.org

Dear Sir, Dear Madam,

Ref. Public Consultation on ERGEG's Draft Guidelines on Article 22

Centrica welcomes the opportunity to contribute to ERGEG's March 2008 consultation on the development of guidelines on article 22 with the aim of bringing greater consistency in the application of regulatory authority decisions on exemption requests across the European Union.

In addition to our activities in our home market of Great Britain, Centrica's existing European activities are concentrated in the north west of Europe, in the Benelux market area and more recently in Germany. We also own a business in Spain.

We do not own any infrastructure that is subject to an exemption decision under article 22, but do have capacity rights in the LNG regasification terminal in the Isle of Grain in Great Britain, whose owner has been granted such an exemption. We have also secured transportation capacity rights in the BBL pipeline.

Centrica is a strong advocate of European energy market liberalisation. The development of guidelines to harmonise the implementation of existing legislation and share best practice among the Member States of the European Union does in our view benefit the future development of the European energy markets.

New investments in the gas sector will be essential to bring new sources of gas to market, not only to help fill the gap from depleting European resources but

also to address the growing demand for gas by European consumers, industry and power generators. The development of new infrastructure projects will also help promote liquidity and competition in the wider gas market. The exemption regime introduced via article 22 is an important incentive tool in that is provides an attractive regime for investors. This regime has already contributed to the development of significant new LNG terminal and gas storage infrastructure in Great Britain and we support its use in this way, provided that the effective functioning of energy markets is not impaired by a loss of information transparency, an increased risk of capacity hoarding or a further accretion of market power. These guidelines must therefore be developed with a view to enhance regulatory transparency of the exemption process for both investors and regulators alike.

Our response is structured according to the questions set out in ERGEG's consultation document.

- Do you consider the described general principles and guidelines appropriate to achieve a consistent and transparent framework for competent authorities when deciding on exemption procedures?

The elements set out in the general principles are appropriate for assessing exemption requests. As an addition, we believe that the ERGEG guidelines would benefit from a glossary section, where terminology is explained in more detail. We also believe that the individual assessment sections would benefit from more detailed explanation, e.g. market and competition assessments. A consistent implementation of any guidelines relies heavily on the interpretation of clear and transparently defined terms and rules.

- Do you consider the present scope of eligible infrastructure to be too narrow?

We do not consider the present scope of the infrastructure eligible under article 22 to be too narrow. Major interconnectors, LNG and storage facilities are those which can genuinely benefit from the incentive of an exemption whilst at the same time delivering the benefits of enhanced competition and security of supply to the market.

ERGEG should not attempt to widen the scope of the eligible infrastructure but instead leave the decision of whether any requesting infrastructure project meets the legal requirement to the individual regulatory authorities, on a case-by-case basis within the framework of the proposed guidelines. For example a certain length of dedicated pipeline connecting the applicant storage facility to the transmission network may in some cases be deemed to be part of that storage facility and subject to the conditions of the exemption, if it is solely for the purpose of using the exempt facility.

- Do you consider open season (or comparable) procedures an important tool in assessing market demand for capacity with respect to determining the size of the project applying for exemption, as well as in the subsequent capacity allocation? Should open season (or comparable) procedures be mandatory?

A clear and transparent process by which market demand for eligible infrastructure is assessed is an important step in investment planning. An open season process is a good mechanism for such an assessment but not necessarily the only or always the best means available. Thus we would not support mandating open seasons for all infrastructure projects.

Elements to be taken into consideration include the type and size of the infrastructure, its impact on the market, the owners of the proposed investment, the degree of competition existing in the market already and whether other mechanisms are available to gauge market demand.

A key consideration is whether the investor company wishes to retain exclusive use of the infrastructure for its own use. Hence a preliminary competition analysis of the market may be necessary before the regulatory authority decides whether an open season process should be required or not (and indeed this should be part of the exemption decision process itself).

For relatively small scale projects in a well liberalised market put forward by new entrants who wish to keep sole use of the infrastructure, there should be few competition barriers for this to be granted. On the other hand, where the project lies in a market where competition is highly concentrated and the investor is the former market incumbent it would be inappropriate to allow the investor sole use of the facility and at least some of it should be open to other shippers. In such an instance, a transparent open season process should be essential. There may also be "hybrid" cases (as with some exempt storage in Great Britain) whereby a non-dominant project sponsor is prepared to offer a modest part of the project capacity to third parties in order to enhance transparency and provide a sound basis for anti-hoarding measures.

Wherever an open season process is required by the regulatory authorities, then the ERGEG guidelines on open season should be used.

- Should open seasons also be used to allocate equity?

We would not generally support the use of open seasons to allocate equity. A possible exception could, however, arise where competition analysis suggests equity divestment (e.g. by a dominant player) as a condition for article 22 exemption. An open divestment process could in such cases be preferable to one by which equity is sold privately to other, already powerful European energy market participants.

- Some stakeholders think that Art. 22 should be applied differently to LNG terminals as they may be generally better suitable for enhancing competition and security of supply than other types of eligible infrastructure. What is your point of view on this? If you agree, how should this be reflected in the guidelines?

We do not believe that there are valid reasons for applying article 22 differently to LNG terminals from any other form of infrastructure. Article 22

expressly states that the rules should be applied on a case by case basis, irrespective of the type of infrastructure in question. Where a particular project does enhance competition and security of supply then those attributes will be taken into consideration by the assessing regulatory authority. The fact that LNG terminals may be better placed to meet these criteria by brining new sources of gas to market does not mean that the article should be interpreted differently, merely that the results of the required tests may award such LNG facilities a greater likelihood of an exemption being granted.

In practice, we envisage that the competition analysis as applied to LNG terminals or gas storage may often be different to that which applies to network infrastructure (which has a "natural monopoly" character) – but this will not always be the case.

- Are the described criteria for assessing the effects of an investment in infrastructure on enhancement of competition in gas supply appropriate?

Although the criteria for assessing the effects of an investment to enhance competition are appropriate, we believe that the guidelines would be improved by including more detailed explanation. This will assist not only regulatory authorities be more consistent in their assessments, but will improve the understanding of the investing company and other market participants of the steps that need to be taken.

Given the in depth competition assessment that is needed for this step, it may also be beneficial to cooperate with competition authorities, as in some markets the energy regulator may not have the skills and resource to conduct detailed market competition tests.

We welcome the suggestion that regulatory authorities in neighbouring Member States should also be given the opportunity to participate in the competition analysis. Where the project under consideration is an interconnector then the national regulatory authorities should ideally conduct a joint assessment. Other facilities may also directly or indirectly benefit a market wider than the national boundaries, especially as European integration develops. For example, some Member States are geologically limited in access to gas storage and rely on the import of flexible gas supplies from neighbouring markets. Thus the involvement of authorities and market participants from other market should be considered.

The authority assessing the exemption request should not rely solely on information provided to it by the investors of the facility, but use other data available to it from other sources, such as any regular market competition studies it may undertake. Here too there are benefits from conducting a consultation with other companies in the market.

- Are the described criteria for assessing the effects of an investment in infrastructure on enhancement of security of supply appropriate?

Similarly to our remarks above on competition, we believe that the section on security of supply would also benefit from more detailed explanation on how a project is expected to enhance security of supply.

It is crucial to note that any project being built to meet security of supply standards, e.g. a strategic storage project, should not be awarded an exemption since it is by definition intended to provide a service to the overall market on regulated terms. Where a facility will serve a dual purpose of strategic investment and market investment, then the security of supply enhancement test should be conducted only on the part that is not being used to meet strategic security of supply requirements.

- Are the described criteria for the risk assessment appropriate?

Whilst the risk assessment should contain an analysis of the return on the investment under normal regulated third party access and under an exempted regime, this will not be possible beyond the immediate term of tariff setting. Some infrastructure projects may request an exemption of say 20 years, but it is highly unlikely that data will be available on regulated terms beyond the next five years or less. The absence of this data should not be a deterrent. It should be up to the investors to prove that the risk to their planned project is such that it would not be advanced within the standard regulated regime. The regulatory authority should then determine whether it is content with this proposal given the information available to it.

- Are the described criteria for assessing whether the exemption is not detrimental to competition or the effective functioning of the internal gas market or the efficient functioning of the regulated system to which the infrastructure is connected, appropriate?

When considering the impact a particular project may have on the wider functioning of the market, the regulatory authority should involve other market participants through a consultation process. This should clearly seek information on how the new infrastructure will link with and impact on existing infrastructure and whether there is any cause for concern.

If the results of this assessment show that there are concerns due to the reliance in the system on one particular piece of infrastructure, then the regulatory authority must take this into consideration. It could, for example, make this concern the subject of a condition on the eligible infrastructure. If reinforcements are needed to the system, these must be put in place prior to the new infrastructure coming on stream so as not to negatively impact on the wider market.

- To what extent should consultations with neighbouring authorities be done?

As mentioned above in response to the question on analysis of the project on enhancing competition, we strongly support the inclusion of and consultation with neighbouring authorities. This should also be extended to market participants in the neighbouring market which may be likely to benefit directly or indirectly from the planned investment. As regional markets develop, such instances would be expected to increase.

- Parts 3.3.1.1 and 3.3.1.2 of the proposed guidelines deal respectively with partial and full exemptions. Do you consider the described decisions (partial/full exemption) appropriate in safeguarding the goal of Directive 2003/55/EC in making all existing infrastructure available on a non-discriminatory basis to all market participants and safeguarding the principle of proportionality?

Whilst article 22 allows for full and partial exemptions, the practicality of a partial implementation is less apparent. Whilst the examples provided in the consultation document do help to explain what is meant by a partial exemption, the inclusion of such examples in the guidelines should be avoided, for fear of being interpreted as the only possible ways of qualifying for a partial exemption. Whether a proposed infrastructure project may qualify for a partial exemption should be determined on a case by case basis.

- Do you believe that Art 22 exemptions should also benefit incumbents or their affiliates? If yes in what way and to what extent?

Article 22 had been drafted in such a way that any company may benefit from an exemption as long as it meets the required criteria. Thus, incumbents and their affiliates should never be discounted out of hand.

On the other hand, the market competition analysis must ensure that a dominant incumbent is not able to benefit unfairly by allocating capacity to affiliated subsidiaries to the detriment of other new entrants. The rules relating to capacity allocation must therefore be transparent and fairly applied to all candidates. For example, data or financial conditions for participating shippers should not create a barrier to new entrants. Similarly, if capacity is being auctioned, the reserve price should not be fixed at such a high level that only the affiliated company is able to pay. In practice, therefore, one would generally expect more stringent exemption conditions to apply in such cases, where exemption can be contemplated at all.

- Do you agree that under certain circumstances, deciding authorities should be entitled to review the exemption? How can it be assured that this does not undermine the investment?

Under certain circumstances, regulatory authorities should be entitled to review the exemption. In so far as possible, these particular circumstances that trigger a review should be established and published at the time of the exemption being granted. Without this, the regulatory risk to the project (or other projects in the same jurisdiction) could undermine investment decisions.

Where a review of an exemption has been triggered, the regulatory authority should, if possible, aim to limit the review to those areas of the exemption and its conditions that has caused concern. For example if one of the shippers who holds capacity at a storage facility is later acquired by a dominant incumbent shipper, the authorities may consider that capacity is no longer fairly allocated. This should not mean that the whole exemption is revoked, merely that some or all of the capacity previously allocated to that one user may need to be re-allocated, if a competition assessment proves the regulator's initial concerns to be true.

- Do you have any other remarks?

We have additional remarks in the following areas: consultation process; conditions to the exemptions; and life after an exemption.

As part of the exemption assessments by the national regulatory authorities, we consider a public consultation to be a crucial step. Market participants and other interested parties should always be given the opportunity of contributing to the regulatory process. As European markets become more integrated, such a process should be as inclusive as possible to those from neighbouring markets, whether they are affected directly or indirectly by the planned infrastructure development.

The conditions applied to an exemption are as important as the analysis of whether an exemption should be allowed or not. As conditions will be designed on a case by case basis, it is difficult for the guidelines to set these out in detail. The conditions must be framed to take full account of the results of the earlier assessments on competition, risk and security of supply. To ensure that all parties concerned are aware of the risks of the project, any conditions must be designed and approved prior to the exemption being formally granted.

Particular areas for careful consideration of exemption conditions include information transparency and anti-hoarding measures and in this respect we believe that the guidelines should be consistent, as far as possible under existing legislation, with the measures envisaged in the "third package" proposals.

Wherever applicable and possible, we would welcome the inclusions of references to relevant ERGEG guidelines in the conditions, e.g. good practice guidelines for storage system operators, on information transparency, for open seasons, or the good practice guidelines currently being drafted for LNG operators. The application of guidelines in this way will help ensure consistent treatment of infrastructure even when exempted.

The conditions to the exemption should also, wherever possible, set out what developments or behaviours may trigger an exemption to be reviewed by the regulatory authority. For example, if the exemption was granted with a condition relating to use-it-or-lose-it as a means to stop anti hoarding, and the behaviour of the owner or shippers later shows that this condition is not being properly applied, the regulatory authority may decide to review the application of that condition.

The regulatory treatment of the facility when the exemption comes to an end should also be given some consideration at the outset. Wherever possible, conditions applied to the exempted infrastructure should be consistent with the wider market rules. This will then make it easier for the owners and capacity users to be integrated into the regulated market at the end of the

exemption duration. As with any change to regulatory terms, these should be discussed, consulted upon and determined as far in advance as possible to allow for the parties concerned to make changes to their own business operations.

I trust that the points contained in this response will aid you in developing the guidelines on article 22. If you have any queries, relating to this response, please do not hesitate to contact me.

Yours faithfully,

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