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With reference to Cross border framework for transmission network infrastructure – An ERGEG consultation paper (Ref: E06-REM-09-04),

Comment relating to merchant model interconnectors and the application of Article 7 of Regulation 1228/2003/EC

This short comment will concentrate only on the last issue raised by the ERGEG consultation paper on Cross border framework for transmission network infrastructure: the merchant model interconnectors and the need to clarify issues relating to the regulatory treatment and applications for exemption under Article 7 of the Regulation 1228/2003/EC (hereinafter “Regulation”).

The comment is based on (i) authors involvement in the Estlink project and (ii) on several studies relating to different aspects relating to interconnectors, notably on:

Kim Talus and Thomas Wälde, *Electricity interconnectors in EU Competition law: Case C-17/03 and tension between full competition, need for investment and long-term contracts*, [2007] European Law Review, February issue (forthcoming)

Kim Talus and Thomas Wälde, *Electricity Interconnectors - a Serious Challenge for EC Competition Law*, [2006] Journal of Competition and Regulation in Network Industries, issue 3

Kim Talus, *Monopolies in EC energy law - Interconnectors*, [2006] 14 Utilities Law Review, issue 16

Kim Talus, *First Experiences under the Exemption Regime of EC Regulation 1228/2003 on Conditions for Access to the Network of Cross-Border Exchanges in Electricity* [2005] 23 Journal of Energy and Natural Resources Law, no. 3

### Content of this comment

This comment will focus on two central issues relating to merchant model interconnectors: the risk criteria under Article 7 (b) of the Regulation and the proceedings at European level.

The comment will first briefly recall the main aspects of the risk related criteria as defined in Article 7. Thereafter it will first argue against this criteria and secondly suggest that the application of this criteria should be clarified and should not be too strict. After the assessment of the risk criteria, this comment shortly suggest that there is a need to alter the administrative practise of the Commission.

### The risk factor under Article 7 of the Regulation

*(b) the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted;*

As is well known, the logic of Article 7 (1)(b) of the Regulation is that the investor(s) must show that the level of risk attached to the investment is sufficiently high to justify an exemption from certain rules such as third party access (hereinafter TPA) and regulated tariffs. In conformity with the principle of proportionality, the exemption should correspond to the level of risk.<sup>1</sup> As an exemption is a deviation from the general rule of TPA, it should always be as restricted as possible.

Factors that demonstrate a particularly high level of risk are: expected overall cost of the project, the expected return on the investment, the foreseen amortisation period and cost of capital.<sup>2</sup> These factors affect the level of risk involved in an investment. In addition to this, the investor(s) should show actual risks associated with the project. These risks can, among other things, be commercial, technical, regulatory or, in some cases, even political.

It is important to note that the commercial risks involved will differ depending on the investors and that they most likely will also be investor specific. The cost of capital, the significance of the investment and the expected return are, in most cases, different for each investor. The question of risk is also related to the question where the return to the investment is expected.

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<sup>1</sup> Note of the DG Energy & Transport on Directives 2003/54-55 and Regulation 1228/03 in the Electricity and Gas Internal Market, Exemptions from certain provisions of the third party access regime. 30.1.2004, p. 5

<sup>2</sup> Ibid.

Technical risks will vary depending on the technology used<sup>3</sup> and the geographical location of the cable. For example, in the Nordic countries, the compaction of ice is a significant risk factor for submarine cables<sup>4</sup>. Also dragging anchors may present risks for submarine cables<sup>5</sup>.

The investors are expected to present exhaustive and detailed assessments of the risks involved and different risk-return profiles under different exemption regimes. The assessments should of course be presented for each of the investor.

A prerequisite for an investment to be considered as risky is that the investment is a sunk cost and cannot be recovered and reused for another purpose. Also, the benefits of the investment need to be difficult to evaluate, owing to the range of possible events such as variations in consumption projections, other competing investments, etc.

In conformity with the principle of proportionality the exemption period is also related to the risk, i.e. the greater risk, the greater the length of the exemption. According to the Commission's note, the exemption period should not be significantly longer than breakeven point for the investors.<sup>6</sup> The Commission expects that the normal length of an exemption could be about 20 years. This figure is likely to be correct, as the amortisation periods in infrastructure investments are often considerable.

In relation to the Estlink project, the authorities found that as the profits are expected to rise from the income from the trading of electricity and the transfer costs payable to the applicant are only intended to cover the project expenses, it is clear that the investment would not take place unless an exemption was granted. This is the correct assessment of the case but, despite of this finding, the Finnish authorities demanded that the investors should provide clarifications on the financial preconditions for the project in various exemption regimes, such as an exemption granted to only a portion of the capacity.

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<sup>3</sup> For example, it is faster and less costly to repair an interconnector built with Light (transistor based) technology and the traditional thyristor based technology and this has an effect on the level of risk a breaking of the cable represents.

<sup>4</sup> This risk materialized during the year 2003 when the so-called Fenno-Skan interconnection was out of operation for two months due to low temperature and compaction of ice. In 2005 the interconnection was out of operation for three months. The damage was found in the same section of the cable as in 2003.

<sup>5</sup> This risk materialized in early 90's and put the Fenno-Scan cable out of operation.

<sup>6</sup> Note of the DG Energy & Transport on Directives 2003/54-55 and Regulation 1228/03 in the Electricity and Gas Internal Market, Exemptions from certain provisions of the third party access regime. 30.1.2004, p. 7

## Assessment

The emphasis of the risks related to the interconnector project indicates that in “normal” situations a merchant model interconnector is not eligible for an exemption. It also gives an impression that the ideology of Regulation is to favour TSO’s as constructors and operators of interconnectors. Consequently, it also indicates that merchant model interconnectors are considered feasible only in certain exceptional cases. In a situation where the level of interconnectors is constantly too low, the merits of this approach may be questioned.

Following the changes in the regulatory and factual situation in EC brought by the liberalisation of the energy markets, the construction of interconnectors is no longer as evident as before. This has already lead to difficulties. For example, there are indications that the insufficient level of interconnectors are at least partially behind some of the resent EU blackouts in Europe. In addition to this, the congestion problems in many of the existing interconnectors are well known.

Because of the above-mentioned issues, there is an urgent need to find ways to attract investments to interconnectors. In this situation, the possibility to make the interconnector project economically viable should not be restricted to cases where the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted. After all, the exemption is not intended for TSO driven projects, although it is submitted that they should not necessarily be excluded from the possibility to get an exemption.

An exemption is arguably necessary for all cases where an interconnector is operated under a merchant model: if revenue is to be acquired from transmission services the exemption should cover at least regulated tariffs; if revenue is to be acquired from trade or power procurement the exemption should cover at least TPA.

Therefore, this comment argues primarily for redrafting of the Regulation to exclude the risk related criteria. Here ERGEG could prepare background material and raise this issue with the Commission.

Alternatively, national authorities should indicate how the risk criteria is to be interpreted and how they will apply this criteria in practise. In the event that ERGEG issues guidance on the application of Article 7 of the Regulation, which is highly advisable, this aspect should be considered in this context.

### Proceedings at EC level

Article 7 (5) of the Regulation states that the information submitted to the Commission should enable the Commission to reach a well-founded decision. It furthermore states that the period to make a decision is two months.

In the Estlink project the Commission informed the applicant that it intends to, and later did, refrain from making a formal decision. Instead, the Commission allowed the aforementioned two month period expire. These means that if the parties had not heard from the Commission within two months from the date the Commission received the notification, they could consider that the Commission had approved the exemption granted by the national authorities.

This possibly emerging practise in the application of Article 7 by the Commission should be altered. The Commission should actually make a well-founded decision, rather than let the period in which the decision must be made expire.

The two month period for the decision should only serve as a legal protection for the applicants, as a guarantee that in case the Commission is unable to reach a decision within a relatively short time period, then at least the parties can be certain that after two months they can proceed with the project. It should not be the praxis in normal cases. As indicated in the ERGEG consultation paper on cross border framework for transmission network infrastructure, the time constraints affecting interconnector projects should be minimised in order to guarantee that administrative proceedings do not stand in the way of beneficial projects.

As the application of Article 7 of the Regulation has not yet formed a body of case law and no administrative practise had born, this issues should be raised as soon as possible. The role of ERGEG in this could be to raise this question in the discussions with the Commission.

### Further issues

In addition to the issues raised above, there are numerous other issues that needs to be clarified. One of these issues was briefly commented above: it is currently unclear which type of interconnector project (TSO or merchant model) the Regulation seeks to promote. A second issue relates to the application of EC competition law to merchant model interconnectors: the product market definition and the application of Articles 81 and 82 EC. These issues are affected by an exemption and it is therefore necessary to clarify them.

As these issues are complex and their assessment cannot be made in this context, a reference is made to:

Charles Zimmerman, *Transmission Interconnectors and Electricity Market Design* [2006] 4 OGEL 1

Kim Talus and Thomas Wälde, *Electricity Interconnectors - a Serious Challenge for EC Competition Law*, [2006] Journal of Competition and Regulation in Network Industries, issue 3