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E07-GFG-31-07 - Draft Guidelines on Article 22 – An ERGEG Public Consultation Paper

Dear Mrs Geitona,

Thank you for the opportunity to respond to the issues raised in this consultation document. The comments contained in this response are offered on behalf of Shell Energy Europe BV. Please note, this response is not confidential and so may be published on your website.

Answers to the specific questions raised in the consultation paper are contained in Appendix A. To accompany those answers, however, we would also make the following general observations regarding the Draft Guidelines (the 'Guidelines').

Nature and Scope of the Guidelines

In developing these Guidelines, care has to be taken that they do not drift towards the imposition of an inefficient, one-size-fits-all model that runs the risk of producing neither a conducive investment environment nor enhancing security of supply. Therefore, just as an exemption should be appropriate to a particular project, so the application of the Guidelines should be appropriate to specific market conditions. We are therefore glad to see that the Guidelines state:

'**Although it is crucial that the form/nature/conditions of any exemption are proportionate to the individual project/market – which will be determined by the underlying competition assessment'**[1]

Notwithstanding the above, the concern about a one-size-fits-all model and, in certain areas, one that goes beyond the requirements of Directive 2003/55/EC (the Directive), persists. One example that demonstrates this concern is the fact that the Guidelines are based on the assumption of Regulated Third Party Access (RTPA) being the default regime in the absence of a Third Party Access Exemption (TPAE), and that the Guidelines are in relation to an exemption from the requirements of RTPA.

Shell would question whether this is correct or whether the Guidelines have inadvertently gone beyond the requirements of the Directive? Shell's particular concern revolves around the fact that the Directive clearly allows Member States the choice to opt for Negotiated Third Party Access (NTPA) as the default

[1] See para 2.7

TPA regime for storage facilities. This is the choice, for example, for which the regulatory authorities in Great Britain and Germany have opted and yet this is not reflected in the Guidelines.

Moreover, the Guidelines seem to suggest that NTPA is a form of TPAE. This is not the case. As with RTPA, NTPA places a statutory obligation to provide non-discriminatory TPA; by definition, there is no TPA requirement in the case of a TPAE. The only difference between RTPA and NTPA is that in the case of the latter income is not price regulated.

There are also other areas where we consider that the Guidelines appear to have gone beyond the requirements of the Directive. Please refer to our answers to Q6 and Q7 respectively.

Shell would therefore urge ERGEG to consider whether these Guidelines have gone beyond the intention of EC law? If so, the Guidelines should be revised accordingly or clarification provided as to the basis on which ERGEG considers such a situation permissible.

Application to Different Types of Infrastructure

Art 22 exemptions are clearly suitable for duplicable infrastructure. As such, this logically means storage facilities, LNG import terminals and interconnectors for which there is a competitive market for the provision of such infrastructure.

The Guidelines suggest that with respect to the application of Art 22, consideration might be given to different treatment of duplicable and non-duplicable infrastructure[2]. Absent of any competition concerns, duplicable and non-duplicable infrastructure **should** be treated differently.

If not, and taking into account that the Guidelines suggest a default RTPA regime, ie. regulated tariffs, it is difficult to see how not doing so would incentivise non-TSO infrastructure investment. The 'special tariff treatment' referred to in para 3.2.3 may be one solution. However, equally it should be noted that the resulting costs of such tariffs would ultimately be borne by consumers.

Open Seasons

The Guidelines place considerable emphasis on the role of Open Seasons. We acknowledge that such a mechanism has an obvious role to play with respect to price-controlled, monopoly transmission networks, not only as a means of assessing market demand, and thus efficient investment decisions, but also as a non-discriminatory capacity allocation mechanism.

Whilst acknowledging this fact, Open Seasons should not be made mandatory. Rather, the need for an Open Season should be assessed on a case-by-case basis, taking the different nature of the projects into account. As we make clear in our answer to Q3, there are clear limitations, if not dangers, in the mandatory nature of such a requirement if it results in uncertainty over the capacity allocation for the project developer.

Clearly, some infrastructure developers may wish to hold an Open Season. However, that should be a commercial matter for them based upon their own project structure and financial projections.

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[2] Para 2.2

It is true that the Guidelines recognise such difficulties by stating that:

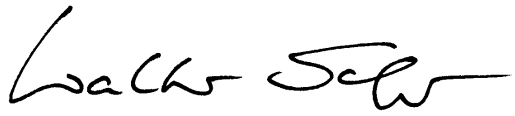
'Where the NRA…..is satisfied the project sponsor has sufficiently proved that an open season would undermine the feasibility of the project, the NRA may not require the project sponsor to conduct an open season.'[3]

However, while we are pleased to see that the Guidelines envisage limitations to a mandatory Open Season requirement, a more efficient solution would be to remove the blanket obligation entirely. There should instead be more detailed ex-ante guidance on the circumstance when an Open Season is required and those in which one need not be held, bearing in mind what we say about a case-by-case approach and the different nature of projects.

I trust you have found these comments and our answers attached in Appendix A useful. Please do not hesitate to contact me should you have any queries.

Yours sincerely,

Shell Energy Europe B.V.



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[3] See para 2.9.

Annex A: Answers to Questions to Stakeholders

Q1. 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?

To a degree, the principles and guidelines may offer some guidance for competent authorities when deciding on exemption procedures. However, as detailed in our covering letter, there are a number of areas where the Guidelines go beyond the requirements of EC legislation.

Shell would request ERGEG to provide clarification as to whether this is indeed the case? If so, further clarification on the legal justification behind such a move should also be provided.

Q2. Do you consider the present scope of eligible infrastructure to be too narrow?

Subject to any competition concerns and issues such as a geographical monopoly, import terminals, interconnectors and storage facilities should be eligible to apply for an exemption under Art 22. There is a competitive market for the provision of such infrastructure and this is a fundamental point to recognise.

Additionally, in terms of capex costs and efficiency, investment by non-TSOs could provide a useful benchmark for regulators when conducting price control reviews for TSOs.

Q3. 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?

In principle, an Open Season may be a helpful means of determining market demand, especially in the case of investments by price regulated TSOs where consumers ultimately bear the risk (in the form of tariffs) of uneconomic investment. However, with respect to the use of Open Seasons for all non-TSO investment becoming a mandatory requirement, there are other factors that need to considered with regards to the type of infrastructure and financing options.

While an Open Season may reveal the level of market demand, this does not necessarily mean that the infrastructure in question can be expanded accordingly. By their very nature, this is particularly the case with storage facilities where there may well be obvious physical constraints that either cannot be overcome or at least not in ways that do not fundamentally place at risk the project economics.

Where, an Open Season is held for a storage facility, it is of paramount importance that it does not become a capacity allocation mechanism that disregards or undermines the financing options envisaged by the project sponsor. In short, where investment in a storage facility is predicated on own-use rights by the developer to some or all of the capacity, any requirement to hold and act on the results of an Open Season could limit the capacity available to the developer, thus endangering the investment; we can only repeat that unlike interconnectors or import terminals, storage facilities have obvious physical limitations that do not lend themselves to expansion of the facility.

Q4. Should open seasons also be used to allocate equity?

This issue should be a purely commercial consideration. In the event that a project developer wishes to allocate or offer equity, an Open Season may be one of way of doing so. However, the most important point to make is that, subject to requirements of transparency and non-discrimination, this decision should be one for the developer to make.

Q5. 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?

LNG import terminals have different characteristics to storage facilities and interconnectors. In contrast to an interconnector or a storage facility – where the gas has already entered the system and the system entry point is embedded in the grid – an import terminal represents a new source of supply and a new entry point at the extremities of the grid. On the basis of these characteristics, an import terminal could be viewed as having greater benefits than other infrastructure in terms of competition and security & diversity of supply.

However, it is difficult to reflect this fact in ex-ante Guidelines without running the risk of discriminating against certain types of infrastructure in the application of Art 22, potentially distorting investment signals. This would be an unwelcome development.

Rather, the above further emphasises the need for a case-by-case evaluation of Art 22 exemption requests. Moreover, any additional benefits associated with import terminals will become clear through application of the existing exemption criteria, without the need for any additional measures, and the national regulatory authority will duly be able to make an appropriate recommendation.

Q6. Are the described criteria for assessing the effects of an investment in infrastructure on enhancement of competition in gas supply appropriate?

Shell agrees with ERGEG's views on the need to define the relevant position. In broad terms, the proposed way of doing so has some merit. We would, however, make the following comments:

- Para 3.2.1 states that 'the deciding authority shall mainly focus on the relevant market.'

  Shell is puzzled by the reference to 'mainly'. It is not clear why the deciding authority should focus on anything else?

- Para 3.2.1.2 states that 'Market shares, concentration levels and barriers to market entry provide useful first indications of the market structure, of the market position and the competitive importance of the applicant and the proposed user.'

  Our comment here would be that being an industry incumbent does not necessarily mean being an incumbent in the *relevant market*. This point should be recognised.

- Para 3.2.1.3 states that an enhancement of competition is not sufficient per se in order to gain an exemption and that any improvement in competition has to be 'substantial'.

  Not only does the qualification of substantial go beyond the requirement of the Directive but its assessment is not defined. As such, it is logical to assume that the judgement of what constitutes

substantial will remain subjective, thus increasing regulatory uncertainty. It would be preferable to acknowledge that any improvement, no matter how small, must by definition be of benefit to consumers, and that this should be the sole criterion.

Q7. Are the described criteria for assessing the effects of an investment in infrastructure on enhancement of security of supply appropriate?

A comment would be that subject to competition concerns and whether it reduces the sources of supply, new infrastructure, regardless of size, should benefit security of supply. It is not clear why this would not be the case.

A far more substantial comment, however, concerns the proposal to allow the NRA to assess the granting of an exemption for the same project to another party. In broad terms, this proposal runs contrary to the operation of markets in that it allocates a quasi-commercial role to regulators. Aside from this point, there are immediate and practical questions to address.

For instance, how would a regulator identify another suitable party? Would the regulator advertise the fact that it was seeking expressions of interest in a project that another party had brought to its attention? If so, what incentive would this place on parties to approach the regulator in the first place?

This is an entirely inappropriate measure and should not be implemented.

Q8. Are the described criteria for the risk assessment appropriate?

As we state elsewhere in our response, the Guidelines ignore the fact that NTPA is also an option as a default regime for storage facilities, so our answer to this question should be seen in that context.

If RTPA were the default regime, then these criteria would seem a standard way of assessing risk. One comment we would make is that para 3.2.3 does not detail what is meant by 'special tariff treatment'. Clarification on this point would be useful.

Q9. 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?

The criteria would appear appropriate and we have no substantive comments to make.

Q10. To what extent should consultations with neighbouring authorities be done?

This should only happen where the relevant market involves two or more Member States. Clearly, the case for this is stronger with an interconnector rather than a storage facility or an import terminal.

Q11. 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?

The point needs to be made that the presumption in the Guidelines is that RTPA is the default regime for storage. This is clearly not the case. Additionally, NTPA is viewed as being a form of exemption.

Again, this is not correct; an exemption from regulated tariffs is not the same as exemption from having to offer TPA.

Notwithstanding this point, para 3.3.1.1 does provide some welcome flexibility viz an RTPA regime that should be supported. In particular, we welcome the advice regarding the validity of long-term contracts, and the exclusion of TPA where an Open Season would worsen competition, especially in the case of investors with a low market share or new entrants.

The criteria described in para 3.3.1.2 would seem generally appropriate. The basis on which the duration of the exemption has been decided needs to be set out clearly as this would offer a greater degree of certainty regarding the grounds on which this decision could be subsequently reviewed.

The requirement for Use-It-Or-Lose-It (UIOLI) rules is one that Shell supports. Such a mechanism is a useful anti-capacity hoarding mechanism. There are two related points to make, however.

A UIOLI mechanism may need to be judged over a period of time before assessing its effectiveness as an anti-capacity hoarding mechanism. The operational nature of an interconnector, a storage facility and an import terminal differs; for example, in the case of an import terminal the effectiveness or otherwise of a UIOLI mechanism might not be apparent over a short period of time.

Given the role envisaged for NRAs in imposing appropriate UIOLI mechanisms, we would urge the Guidelines to recognise that in doing so, the NRA should be aware of the impact of its decision on the rights of the original capacity holder. A better solution would be to do away with the need for any ex-ante regulatory approval.

Q12. Do you believe that Art 22 exemptions should also benefit incumbents or their affiliates? If yes in what way and to what extent?

If an Art 22 exemption request passes the necessary tests, it is difficult to justify treating one type of applicant differently to another. To do so may raise questions of subjective and undue discrimination.

Q13. 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?

The deciding authorities should be able to review exemption decisions but in doing so might want to be conscious of how favourable and certain regulatory arrangements become in comparison with markets in other parts of the world. Therefore, apart from compliance with any general legal requirements, eg. competition law, the necessary regulatory certainty & stability that would encourage infrastructure investment means that the basis on which **any** aspect of the exemption can be reviewed must:

a) be set out clearly and unambiguously in the exemption approval; and

b) not be subject to an ex-post arbitrary review (or even the threat of a review) by the regulatory authorities.