European Federation of Energy Traders
Working Document of the Gas Committee
8 May 2008
EFET response on Article 22 exemptions

Executive summary

A fully functioning and liquid EU gas market needs ongoing development of infrastructure to increase competition, ensure security of supply and deepen market integration.

Three very different types of major gas infrastructure, namely interconnectors, LNG reception terminals and gas storage projects can be excluded, under Article 22 of the Gas Directive, from some or all of the requirements of Third Party Access (TPA). Significant investment in the European gas market has taken place using this regime. Problems remain with delays and lack of co-ordination in the development of pipeline infrastructure. But these problems would be addressed better by improving the co-ordination of investments that should be made by regulated Transmission System Operators (TSO) rather than widening the use of exemption procedures.

The EU regulatory regime should provide greater clarity as to what investments the regulated grid operators (TSOs) should be making to build new or enhanced interconnection capacity between their regulated TPA pipeline infrastructure. The guidelines could then usefully point out that the intention in the Gas Directive is that only projects that are not the responsibility of TSOs should be considered for TPA exemption under article 22.

We support guidelines that provide certainty and consistency in the application of Article 22 so that developments continue in the direction of a single EU gas market. More focus on the '5 tests' and their consistent application across the EU would be useful, in particular detail is needed on the competition analysis process.

Operators of major infrastructure that obtain exemptions under article 22 should still bound by a) the requirements on the provision information about aggregate infrastructure use and b) the offer of unused capacity to the market. – we note that this is proposed by the EU Commission to be addressed in the 3rd package.

Our comments on the ERGEG consultation questions are set out below.

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Answers to the ERGEG Consultation on Draft guidelines
(Ref: E07-GFG-31-07, 5 March 2008)

Article 22 exemptions

♦ *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?*

- An exemption from TPA for new gas infrastructure must be for an individual case, but assessed in the same way for all projects. We therefore welcome detailed guidelines that remain within the scope of the legislative text of the Gas Directive.

- Consistency and transparency in the regulatory decision making process is essential, but it is not clear that these guidelines require Regulators to be transparent about their assessments under article 22, nor that the methodologies described in the guidelines would lead to the same results when applied by different regulators.

- Notwithstanding the comments below, the combination of general principles and more specific guidelines provide a good basis for developing a robust framework for Article 22 exemption decisions.

- Competent authorities should demonstrate they have used the guidelines in deciding on an exemption application and ERGEG (ACER) could have a reporting role in this respect.

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

- It should be made clear that the guidelines only apply to major infrastructure.

- There are also inherent differences between interconnectors, LNG terminals and storage; the goal of a single gas market implies an integrated transmission grid for which there is fair and non-discriminatory EU-wide regulated TPA for this monopoly service, whereas the goal for storage could be a competitive service in many parts of Europe. This could, and indeed should, also be clarified in the scope.

- Regarding pipeline infrastructure, it is essential that the obligations and responsibilities of TSOs to ensure adequate interconnection capacities between their systems is absolutely clear. It is only those projects that are outside the responsibility or obligations of a regulated TSO that should be considered for article 22 exemption.

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♦ *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*?

- EFET has made its views clear on Open Seasons (see www.EFET.org January 2007, and the Annex at the end of this document)
- Well-designed Open Seasons can be an effective way to allocate capacity.
- However, an Open Season is not the only principle to determine capacity needs for special projects. If an exemption is subject to a case-by-case analysis, an open season should not be mandatory.
- Clarification on what constitutes an open season (expressions of interest, auctions for limited amounts of capacity) would be welcome, for example whether or not the approach by Spanish and Italian authorities on LNG terminals constitutes a valid interpretation of Article 22 procedures.
- Unfortunately, most recent experience with Open Seasons fails to deliver either the clarity on economics or the consistency between TSOs and regulators that are both needed for efficient interconnector investment.
- Improvements to Open Season procedures are urgently needed if they are to be used as a key tool in the article 22 decision process.
- When considering whether an open season should be employed it is important to consider fully whether or in what form an open season may or may not be practicable
- Other methods of offering and allocating capacity may be appropriate, but they must still meet the key tests.

♦ *Should open seasons also be used to allocate equity?*

- No, open seasons must not be mandated for equity allocation. This could undermine the business plan.
- Infrastructure projects need reliable investors and structures for financing. Either the bankable (financing) structure should exist though the normal regulated regime, or if there is an exemption from regulated TPA then there must be no regulatory interference in the financing of the project.
- If an investor could force its way into a JV that might severely compromise the operation of the JV company, particularly if the new equity holder were not an approved counterparty of the existing equity holders. This might even provide a vehicle for preventing the development new capacity!

♦ *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?

- If the competition assessment is undertaken properly it should identify whether an LNG project is particularly beneficial to competition and security of supply – the application of Article 22 should be 'technology neutral' otherwise there is a risk that investment decisions will be distorted. However, further guidance may be necessary to ensure that the assessment takes account of the differential impact that infrastructure type may have on competition and security of supply.

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

- The list of criteria that the applicant must provide is appropriate apart from: "existing and (other) potential competitors; and comparing and ranking the proposed project with other existing and planned project". Clearly, a view will have been formed about the commercial viability of the project taking into account possible future market developments but this cannot be used to rank the project against hypothetical projects that may or not be developed by other parties.
- In assessing the impact of the investment on competition, the NRA should take into account additional information that it should hold as part of its existing duty to monitor the level of competition in the market. For example switching rates in the retail market, wholesale liquidity and past capacity usage of similar facilities. This information is particularly relevant if the investor is an incumbent.
- It is crucial that competent authorities take into account the greater likelihood that competition will be enhanced when an exemption is given to a new entrant. The only way a new entrant exemption could be detrimental to competition would be if the incumbent had managed to secure a sufficient level of capacity (for example through an open season process) that gave rise to competitive concerns.

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

- Diversification of suppliers should be added to the criteria as this will enhance security of supply.
- Security of supply[1] (e.g. reliability of deliveries) as well as competition could also be enhanced by increasing the capacity of existing infrastructure. Such an increase might have the same risk profile as a new investment and

[1] Investment to enhance pipeline capacity to maintain secure of supplies to customers is a basic responsibility of the regulated TSO and should be covered by the normal regulatory regime.

should not be treated differently.

♦ *Are the described criteria for the risk assessment appropriate?*

- It is difficult to see how regulators will be able to develop a hypothetical regulated benchmark to compare against the proposed exemption. It is not possible to compare the financing of such projects under a system of regulated TPA with the financing under TPA exemption. Information concerning the regulated gas network, tariffs and demand would not necessarily be known over the lifetime of the proposed project

- The project sponsor should be able to demonstrate to the regulator the underlying level of risk associated with the project – including through sensitivity analysis of its business plan.

♦ *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 applicant would not have all of the necessary information to demonstrate the final impact on connected infrastructure. It should be the responsibility of the competent authority, when consulting on the exemption application, to seek the views of all market participants – including owners and users of connected infrastructure – to understand the impact of the exemption.

- The assessment should also examine whether an exemption would have a material effect (positive or negative) on liquidity in the relevant wholesale market.

♦ *To what extent should consultations with neighbouring authorities be done?*

- Coordination between authorities is crucial to ensure a smooth, consistent and transparent exemption assessment process. In the case of an interconnector, consultation and decisions should be made jointly by the competent authorities in the directly connected markets.

- For other infrastructure, it is important to look at the 'relevant market'. If the investment in one country has the potential for a significant impact elsewhere then the relevant competent authorities should be consulted along with market participants. These views should be taken into account by the 'host competent authority' in deciding on the exemption application.

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♦ *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 guidelines should not describe in detail the form of partial exemption that could be used as this should be determined by the competition assessment on a case-by-case basis.

- It would be better if the guidelines identified a range of possible options (or 'tool kit') available to a regulator to mitigate competitive concerns including the use of partial exemptions and/or specific conditions or requirements.

- Any conditions imposed on a new entrant should be kept to an absolute minimum given the clear competition benefits the project will deliver.

- Conditions that increase risk might be counterproductive as these push up the required rate of return – this might include undue limits on own use or on the duration of the exemption.

- Conditions that help maximise capacity utilisation can be beneficial as long as they are not over regulated – e.g. congestion management /anti-hoarding should be developed by the infrastructure operator through consultation and subject to regulatory approval.

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

- The same rules should be applied for every investor irrespective of his existing market position. The effect of new infrastructure on the market is key. Investment in new infrastructure should not be limited by excluding incumbents.

- For the assessment of a dominant position or rather 'incumbency' the definition of the relevant market and the definition of incumbency are of utmost importance. For this further harmonization should apply in order to examine whether a wider regional market has to be assumed.

- Incumbents, along with other investors, should be allowed to apply for an exemption. However, if the competition assessment is undertaken properly, it is difficult to see where granting an exemption to a dominant incumbent in their own home market would benefit competition, unless stringent conditions/requirements are put in place.

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♦ *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?*

- Regulatory certainty is crucial for investment decisions. Any mandated requirement to review an exemption after a defined period of time will seriously undermine investment. That said, a competent authority should always have the option of reviewing an exemption but only if market conditions and structure have changed such that the exemption is now detrimental to competition and security of supply. For example, rates of return in excess of those anticipated under the initial project plans would not be sufficient evidence to constitute a review of the exemption whereas a review might be warranted if there were ongoing failures to allocate unused capacity or a serious reduction in liquidity in the relevant wholesale market.

- A review should only be undertaken in circumstances where the competent authority demonstrates with evidence why it is necessary. Transparency in the review process would be crucial to ensure that confidence, both in the market and in future investment decisions, is not undermined.

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Annex – EFET's position on Open Seasons

EFET has made its views clear on Open Seasons (see www.EFET.org January 2007) this response concluded that:

> "Our comments reflect some concerns about the use and design of such procedures that may be counterproductive to the aim of efficient investment and the development of further competition. There is a role for Open Seasons in the investment decision, but participants should expect to have greater clarity on the costs and expected outcomes from such procedures if they are to deliver better outcomes than in the past."

What EFET said at the 12th Madrid Forum about Open Seasons (item 7. Guidelines for Good Practice for Open Season - Draft report from ERGEG)

"Firstly we would expect that the primary way a TSO (and other developers) would assess the future capacity needs for its infrastructure is through market analysis. Open seasons can be used to help.

There are six key principles that EFET considers important when considering Open Season procedures, and we would urge ERGEG to ensure that these principles are followed in their guidelines:

- EFET understands that an Open Season is an umbrella for two processes; information gathering and capacity allocation.
- Coordinated and timely decisions are essential, with scope for users to demand additional processes.
- The process should allocate appropriate risks to users and to TSOs and requires approval and commitment from Regulators as well.
- Capacity investment should not be limited where such investment is economic and efficient.
- The principles for allocation of capacity must be known at the outset of the process.
- Although it is a heavy process, a frequent (e.g. every 2 years) repeated exercise is necessary in order to test and to meet changing users' requirements/needs.

Finally, Open Seasons can be used in many circumstances; however, EFET considers that the detailed process described in the guidelines is only appropriate for major new infrastructure".