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Brussels, 12 July 2005
D/674

Your Excellency,

On 12 April 2005 the government of the United Kingdom submitted a decision to exempt the BBL pipeline from the requirements relating to third party access contained in Articles 18, 20 and 25(2-4) of Directive 2003/55/EC of the European Parliament and of the Council of 26 June 2003 concerning common rules for the internal market in natural gas and repealing Directive 98/30/EC¹, under the provisions of Article 22 of that Directive relating to major new infrastructure projects.

The BBL project has been developed mainly at the initiative of the Dutch gas transmission company Gasunie Transport Services (GTS). The capacity of the interconnector was determined on the basis of an open season procedure with the result that a pipeline with capacity of approximately 1.75 mcm/hr is to be constructed [...].²

Previously, on 5 December 2003, the UK regulatory authority had sent a draft exemption decision to the Commission. The Commission services subsequently commented on this draft decision by letters dated 30 January 2004 and 12 May 2004. These letters set out the view of the Commission services that an exemption for the project was likely to be acceptable provided that certain conditions were fulfilled. In particular, among the conditions set out by the Commission services were those stating that that the exemption should not exceed the period of the initial contracts [...] for the capacities concerned, that reverse flow nominations (i.e. in the Direction from the UK to the Netherlands) should not be covered by the exemption, and that the UK retail market, in particular, should be kept under review and appropriate action to be taken where the position of the parties involved on the relevant geographic and product market is strengthened to such an extent that competition would be impeded. On the basis of the draft decision of the Regulator and the observations of the Commission services in the two letters referred to above, the BBL Company took the decision, on 26 May 2004, to proceed with the project. A press release was issued to this effect. The first construction activities on the project started in [...].

Mr John Grant CMG
Ambassador
Permanent Representation
of the United Kingdom
Avenue d'Auderghem, 10
1040 Bruxelles

¹ OJ L 176, 15/07/2003, p. 57.

² [...] indicates confidential information which has been deleted for publication.

The documents submitted by the UK regulatory authority on 12 April 2005 set out updated views on the conditions contained in the letters of the Commission services of 30 January 2004 and 12 May 2004. Following this, the Commission services wrote to the UK and Dutch authorities on 10 June 2005 in order to request more information and to extend the deadline for the Commission to respond to the notification until 12 July 2005. A further letter, received from the Dutch authorities on 20 June 2005 and endorsed by the UK authorities, sets out some further observations on the conditions contained in the Commission's comfort letters.

It is noted for the record that, on the receipt of the formal notification on 12 April 2005, a notice was placed on the DG Energy and Transport website inviting observations from market participants. No written comments have been provided in response to this notification.

Summary of submissions

The submissions of the UK and Dutch authorities note that although the project had de-facto gone ahead on the basis of the letters of the Commission services of 30 January 2004 and 12 May 2004, it was considered that the conditions relating to the reverse flow nominations and the duration of the project to no longer be necessary and that an exemption covering nominations in both directions for the full capacity of the pipeline, for a period extending to the expiry of the longest underlying contract, that is to say until December 2022 would fulfil the criteria in the Directive.

Regarding the duration of the contract, it is argued that the exemption until December 2022 is justified since;

- the BBL pipeline will be in competition with other import routes into the UK and not be in a position to abuse any dominant position,
- there was an open season during which other potential shippers had the opportunity to bid for capacity,
- [...] and that the duration of underlying contracts should not be the only consideration in this respect; and finally,
- that a risk exists during the period 2016-2022 that regulation of a part of the capacity after 10 years have passed will also impact on the underlying 15-year contracts. In particular, if capacity was made available during this period at a lower price than in the underlying contracts, the contract between BBL and shippers requires that this price must also be offered to the holders of the underlying contracts for the contracted capacity.

However, both the UK and Dutch authorities suggested that the exemption could be amended or revoked for the part of the capacity for which the contract expires in 2016 in the event that the arrangements for selling capacity in the 2016-22 period were considered detrimental to competition.

Regarding the question of reverse flow nominations, it is argued in the submissions that because contractual counter flow can only be offered on the basis of the physical forward flow, this would give rise to practical regulatory problems, particularly in determining the

appropriate cost basis for a regulated tariff. It is also noted that the physical reverse flows are not possible due to the configuration of the infrastructure.

It is further argued, that on the basis of the underlying contracts, BBL has the right to determine the tariffs for this service in line with the market and does not need the consent of the original shippers, meaning that there would thus be less need for regulation. The submissions also note the possibility that the [...] main shippers would make this service available on a secondary market basis.

Commission Evaluation

The project corresponds to major new infrastructure in the sense of Article 22 of Directive 2003/55/EC [...]. No significant work had taken place on the project concerned at the date when the Directive entered into force.

The decision to exempt the project is required to fulfil the criteria set out in Article 22 of Directive 2003/55/EC as follows:

- (a) the investment must enhance competition in gas supply and enhance security of supply;
- (b) the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted;
- (c) the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built;
- (d) charges are levied on users of that infrastructure;
- (e) 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.

Of these five criteria, the exemption decision as drafted by the UK regulatory authority fulfils criteria (c) and (d), that is to say that the company owning the project will be a legally separate company and that the use of the infrastructure will be subject to specific charges.

Regarding criterion (a), it is considered that the project will improve security of supply, particularly for the UK. It also has the potential to enhance competition in the UK. On this subject the regulatory authority has noted that it will keep the UK retail market, in particular, under review and suitable remedies are available, with respect to the natural gas imported using the exempt infrastructure, to deal with potential abuses of market power. In relation to the Dutch market, criterion (a) relating to competition will only be fulfilled provided that the project improves access to the Dutch market by companies based in the UK. This will only be the case provided that fair and non-discriminatory access is available for reverse flow nominations from the UK to the Netherlands and this can only be assured through the application of regulated third party access as set out in Directive 2003/55.

In relation to criterion (b), the level of risk attached to the project is sufficient to mean that the project developer needs to secure initial long term contracts with shippers to ensure that the costs of the project can be repaid. These initial contracts underlying the viability of the project run from 2006-16, i.e. ten years, for [...] of the capacity to be constructed and from 2007-22, i.e. fifteen years, for the remaining capacity. However, the Commission considers

that the duration of the exemption should not go beyond these respective periods for the capacity concerned since this would go beyond the period necessary to ensure that the project progresses and therefore not comply with criterion (b) of Directive 2003/55. Neither should the exemption cover nominated flows in the direction from UK to the Netherlands for which no contracts are in place and for which no account has been taken in the business case for the investment.

Regarding criterion (e), the Commission considers that, if the exemption is applied for flows nominated in the direction United Kingdom to the Netherlands, this will mean that tariffs and conditions for use of the infrastructure will be at the discretion of the pipeline owners and/or capacity holders. There therefore remains the possibility that access to this interruptible reverse flow capacity could be offered on unreasonable terms which could represent a barrier to the integrity of the European gas market and result in a detriment to the functioning of the internal gas market.

It is therefore considered by the Commission that the exemption, as currently formulated does not therefore fully fulfil criteria (a), (b) and (e) of Article 22 of Directive 2003/55 and should also be amended in this respect. In reaching this assessment, the arguments of the UK and Dutch authorities set out above are not accepted. The reasons for this are set out below.

Duration of the exemption

Regarding the duration of the exemption, Article 22(3)(iii) of the Directive requires account to be taken taken of the duration of underlying contracts and of the time horizon of the project.

However, although the Directive is clear that the time horizon of the projects is relevant to the analysis, this does not imply that the exemption duration should match the developers' estimate of the "break-even" period. Since exemptions from third party access are an exception from the general rules in the Directive, these should not go beyond what is necessary for the project to proceed, which in this case, was related to the time periods of the underlying contracts. Since, in the case of BBL there are no linked upstream contracts to be considered, the only contracts relevant are those relating to transmission through the pipeline. Given that the developer has shown the intention to proceed with the project on the basis of the exemption covering the duration of the underlying contracts, the longer time horizon for the project should not be determining in the present case.

In this context, the existence of competing pipelines, or the fact that an open season process was followed, are not sufficient reasons to allow for a longer period for the non application of the Directive's rules on regulated third party access since this would call into question the whole basis for the Directive. In any case, these considerations would already be taken into account as requirements under the criteria associated with competition and the internal market. They are less relevant to the issue of project duration and risk.

Regarding the argument that the initial underlying contracts could be affected during years 2016-2022, it is considered that regulatory authorities would take this into account in approving the tariff methodology for the period concerned. Indeed, the very fact that the contracts include provisions relating to this possibility implies that such a situation is considered to be workable by the contract parties.

Finally, the fact that the UK and Dutch authorities have offered the possibility of reconsidering the exemption during the period 2016-2022 for the relevant proportion of the pipeline no longer under contract is not seen as adequate in this respect since it reverses the mechanism foreseen by the Directive, given that exemptions are supposed to be an exception to the normal TPA regime.

Reverse flow nominations

Regarding the issue of reverse flows, the Commission is not convinced by the argument that the BBL Company could, without regulated TPA, be relied upon to make reverse flows capacity available on reasonable terms. Under the terms of the transmission contracts between BBL and shippers, the vast majority (85%) of any payments made to the BBL Company for such a service would be returned to the three main shippers. Therefore the incentives on the BBL Company in this respect are not strong.

[...]

Finally it is even arguable that, since there is no actual physical capacity for reverse flow covering nominations in the Direction UK to the Netherlands, that the Directive does not, in fact, provide for such an exemption to be awarded.

In this context it is noted that the potential problems in determining an appropriate cost base for reverse flow could be overcome through the regulators approving a market based methodology. In this context it is noted that the Directive requires the regulator to approve ex-ante the methodology for calculation of network tariffs, not necessarily the tariffs themselves.

Conclusion

In conclusion, the Commission, having examined the exemption order adopted by the United Kingdom regulatory authority and notified to the Commission on 12 April 2005, and the subsequent correspondence, considers that the exemption will meet the criteria in Article 22 of Directive 2003/55 only if it is amended such that the exemption is only applied to cover the periods and capacities covered by the initial contracts, that is to say 10 years (2006-16) for [...] (1,15mcm/hour) and 15 years (2007-22) for the remaining capacity.

In addition, both during this period and subsequently, the Commission considers that reverse flow nominations (i.e. in the direction from the UK to the Netherlands) should not be exempt from the provisions of Directive 2003/55/EC. In particular, the BBL Company should be required to offer interruptible reverse flow services through a non-discriminatory and transparent market based mechanism and required to let the regulatory authorities assess if the mechanism is non-discriminatory and market based as envisaged by Article 25 of the Directive. The regulatory authorities should also have the right to require modifications in this respect. The approved methodology should also be published, as required by Article 18.

Following the analysis of all submissions, this decision therefore confirms the main points of the guidance already provided by the Commission services in its letters of 30 January 2004 and 12 May 2004.

By virtue of the third subparagraph of Article 22(4) of Directive 2003/55 the Commission hereby requests the United Kingdom to amend the exemption order accordingly within four weeks upon receipt of the present letter and to inform the Commission of this amendment.

Yours sincerely,

(signed)