

Assessment of criteria for exempting new interconnectors

A CEER Position Paper

**Ref: C05-EWG-22-04
28 March 2006**

1. Introduction

The purpose of this paper is to provide guidance to regulators on exemption requests and the criteria and conditions for granting an exemption for an interconnector investment according to Directive No 2003/54/EC (the Directive) and the Regulation No 1228/2003 (the Regulation). Without being entirely prescriptive as to the approach which may need to be taken in individual cases, publication by CEER of the initial views of the criteria and the types of assessments which may need to be undertaken by the regulatory authorities¹ in considering any exemption request may also provide market participants with an indication of the types of matters relevant to the assessment of any exemption request.

Please note that this document is without prejudice to any decision of the European Court.

2. Legal conditions for granting an exemption

The Directive and the Regulation set out a number of requirements which are to be applied to interconnectors, covering such matters as the introduction of third party access and the use of congestion management revenues. Article 7 of the Regulation provides that new direct current (DC) interconnectors may upon request be exempted from the provisions of article 20, 23(2), (3), and (4) of the Directive and article 6 (6) of the Regulation. Exemptions may also be granted, on request, for significant increases in the capacity of existing interconnectors. Furthermore, the exemption regime may, in exceptional cases, be applied to alternating current (AC) interconnectors. For ease of reference, the relevant extracts from the Directive and the Regulation are annexed to this paper.

The exemption from articles 20, 23(2), (3), and (4) of the Directive means that new interconnectors² may be exempted from obligations to provide for third party access (TPA) and the publishing of tariffs for the use of the new interconnector. The exemption from article 6 (6) of the Regulation means an exemption from the controls over how revenues from the allocation of the interconnection capacity may be used.

The granting of exemptions under the Regulation is to be done on a case by case basis. This is based upon a set of criteria reflecting the binding conditions that includes both factual prerequisites (see criteria c, d, e below) and assessments regarding the impact of any exemption on existing market arrangements (see criteria a, b and f below). In making such assessments the relevant regulators will need to reach a view on the impact of such exemption, having regard to the facts of the case and the prevailing situation within their respective national markets. Such analysis may identify additional considerations that need to be taken into account in applying the criteria set out in the Regulation to the national circumstances of the case.

Article 7 of the Regulation defines the criteria for granting an exemption, requiring that:

¹ Regulators or other competent authorities according to national legislation.

² In this document the term "new interconnector" refers to all the cases foreseen in article 7 of the Regulation.

- a) The investment must enhance competition in electricity supply;
- b) The level of risk attached to the investment is such that the investment would not take place unless an exemption is granted;
- c) The interconnector 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 interconnector will be built;
- d) Charges are levied on users of that interconnector;
- e) Since the partial market opening referred to in article 19 of Directive 96/92/EC, no part of the capital or operating costs of the interconnector has been recovered from any component of charges made for the use of transmission or distribution systems linked by the interconnector.
- f) The exemption is not to the detriment of competition or the effective functioning of the internal electricity market, or the efficient functioning of the regulated system to which the interconnector is linked.

Article 7(4) also states that the exemption may include explicit conditions that should be established on a case by case basis, regarding:

- The duration of the exemption according to the lifetime of the investment;
- The provision of non discriminatory access to the new interconnector;
- National circumstances;
- Rules or mechanisms on the management and allocation of the capacity.

The Regulation (Article 7(5)) sets out a number of procedural steps that must be followed by Member States or regulatory authorities in considering any request for exemption. These include requirements that:

- The decision including the established conditions should be justified and published;
- Consultation must take place with Member States or regulatory authorities concerned;
- The exemption decision is notified to the Commission, and accompanied by the submission of all relevant information.

Under the Regulation the Commission may, within prescribed timescales, request that an exemption decision taken by a Member State is amended or withdrawn.

3. The note of DG Energy & Transport

DG Energy and Transport published a note³ in which the Commission states their point of view regarding exemptions from certain provisions of third party access regime.

According to this note, an exemption may be granted for all or part of the capacity, as stated in article 7(4) and that the exemptions foreseen in the EU legislation can be of different types, including:

- There may be full exemption from TPA which means that the investors may retain full use of the new interconnector's capacity and do not allow TPA for the lifetime of the project. In this case there is no obligation to publish tariffs and no possibility of ex-post intervention.
- There may be only a partial exemption from TPA where the investors may allow TPA not based on published tariffs but where a so-called "open-season", an auction or individual negotiation may be offered to potential users. In this case, regulators [or competent authorities] should approve the method for offering the capacity and there is no possibility of ex-post intervention.
- Exemption may be only granted for the use of the revenues from congestion management mechanisms. In this case the congestion management guidelines apply and the methodology for solving the congestion must be evaluated by the regulators but the revenues may be used for a different purpose than the ones set out in article 6 (6).

The Commission's note also states that the possibility for such exemptions is clearly an exception to the general rule of third party access which is the basis of the new competitive market for electricity and gas and that exemptions will therefore only be granted exceptionally and on a case-by-case basis.

The note also sets out the Commission's view that the applicant for the exemption bears the burden of the proof that the necessary conditions are met and the criteria is fulfilled.

Furthermore it is pointed out in the note that exemption from Directive and Regulation does not give an exemption from competition law and the possible intervention from competition authorities will always exist.

³ "Note of DG Energy & Transport on Directives 2003/54-55 and Regulation 1228/03 in the electricity and gas internal market" from 30 January 2004; see Annex.

4. Assessing the criteria

When requesting an exemption, the investors must, as far as possible, assess all the different criteria set out in the Regulation, presenting detailed studies. Investors may also submit details of special conditions that the investors intend to fulfill, demonstrating how these conditions will contribute to the criteria satisfaction.

The following text presents, from a regulators point of view, guidance on matters that can be relevant for assessing the criteria.

a) *“The investment must enhance competition in electricity supply”*

A complete competition assessment should include an analysis of the current market situation and the expected future market situation in the light of the new interconnector. Such an assessment is likely to cover and take into account the following issues:

- An analysis of any changes to the competitive conditions expected to occur in the upstream and downstream markets as a result of the new interconnector.
- An analysis of existing market concentration and whether the new interconnector has the potential to reduce or increase any concerns regarding market concentration.
- Whether there are existing barriers to market entry and the extent to which the new interconnector will facilitate new entrants into the market and increase the number of agents.
- Whether the new interconnector will improve trade within the internal electricity market.
- Whether the new interconnector increases or reduces the scope for anti-competitive behavior.
- Whether appropriate information will be available or is capable of being made available in order to ensure that competitive behavior can be appropriately monitored.
- Whether the new interconnector will lead to the identification of new opportunities for electricity trading into liquid and efficient markets (day ahead markets and others).
- Whether the investment is expected to reduce congestion at the borders.
- An analysis of the ownership structure of the investment,

The applicant may propose special conditions for ensuring that the exemption is not to the detriment of competition or the effective functioning of the internal electricity market. These conditions may include:

- Launching an initial offer of the available capacity to the market such as an “open season”, explicit auctions or any other transparent and non-discriminatory capacity

allocation mechanism into the market. Such initial offers could facilitate the appropriate sizing of the interconnector. The initial prices paid by the capacity holders that result from these market based capacity allocation mechanism should be published.

- Establishing mechanisms that ensure the use it or lose it principle is applied to the capacity allocated, demonstrating that there will not be unoffered capacity in the new interconnector when it will start operation. Rules should be evaluated and published.
- The existence of a secondary market for trading the capacity rights with published rules and prices.
- Provisions to make unused or unallocated capacity available to the next allocation timeframes (intraday and balancing timeframes for example) markets are also clearly important conditions in ensuring that capacity will not be hoarded in the market.

The applicant may also propose that they fulfill other special conditions such as the divestment of existing interests or even changes in ownership of assets that contribute to reduce the market concentration. Any such proposals will need to be considered as part of any competition assessment.

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

If the project, considered under the regulatory framework, has a high risk or is too costly or risky to be covered by regulated tariffs, an exemption may be given and investors will be allowed to retain a part or all of the returns from the project.

Hence when requesting an exemption, investors should provide a complete assessment of the investment risks. This assessment is likely to include:

- Consideration of the overall investment costs, including all possible additional costs;
- Possible uncertainties in development, such as construction costs and delay to the date when the new interconnector will be available to the market;
- Analysis of the markets that will be served by the new interconnector, the uncertainty associated with those markets and the potential revenues for the project under different scenarios;
- Analysis of the costs of operation and maintenance and the risk related to the operation of the new interconnector, e.g. the risk of damage, among other things;

- Possible future competition risks, related for instance to new competing infrastructure projects that may come into place;

- c) *“The new interconnector must be owned by a natural or legal person who is separate, at least in terms of its legal form, from the system operators of those systems to which the new interconnector will be built”.*

While legal separation from the *transmission* system operators in whose systems that new interconnector will be built is the minimum requirement, additional separation, such as ownership separation, would increase transparency. Separation arrangements must be sufficiently robust and must be capable of appropriate monitoring and enforcement by regulators in order to help ensure that any capacity that is made available to third parties is done so in a fair and non-discriminatory manner.

Applicants should explain how such requirements will be met.

- d) *“Charges are levied on users of that interconnector”*

One of the differences between a regulated new interconnector and a new interconnector that asks for an exemption concerns the remuneration of the investment.

An exemption granted to a new interconnector may provide that the investment will not be part of the regulated asset base and the costs of the investment will not be recoverable from access tariffs. In such instances the remuneration of the investment must come from the users of the new interconnector with no cross subsidization between the regulated asset base and any such non regulated investments.

Criterion c), which requires, as a minimum, legal separation between the owner of the regulated transmission assets and the owner of the new interconnector, will help to ensure that charges are levied appropriately and that no such cross-subsidization takes place.

Applicants should explain how such requirements will be met.

- e) *“Since the market opening referred to in article 19 of Directive 96/92/EC, no part of the capital or operating costs of the new interconnector has been recovered from any component of charges made for the use of transmission or distribution systems linked by the new interconnector”*

This criterion intends to exclude the entire existing infrastructure. All new investments will automatically fulfill these criteria.

- f) *“The exemption is not to the detriment of competition or the effective functioning of the internal electricity market, or the efficient functioning of the regulated system to which the new interconnector is linked”.*

The competition assessment under this criterion draws on the information and assessments made under criterion a).

However it is also necessary to consider a range of relevant technical issues and interactions in order to ensure that the new interconnector will not impact adversely on the operation of the networks that it will be connecting to. For example, it will be necessary to ensure that the new interconnector operator will be bound by all relevant technical and safety rules and responsibilities and that all appropriate contractual (and commercial arrangements) with the connecting systems are entered into.

When assessing the effective functioning of the market, investors should have to consider the criteria that would be applied under the relevant regulatory framework in assessing the need for and impact of new investment in transmission network infrastructure

Annex 1

Exemptions from Regulation No 1228/2002 and Directive 2003/54/EC

According to Article 7 of the Regulation (EC) No 1228/2003, new direct interconnectors may upon request be exempted from the provisions of article 20, 23(2), (3), and (4) of Directive 2003/54/EC and article 6 (6) of the Regulation. In exceptional cases the exemption can also be applied to AC interconnectors or to increases of capacity in existing interconnectors.

Article 7

(1) New direct current interconnectors may, upon request, be exempted from the provisions of Article 6(6) of this Regulation and Articles 20 and 23(2), (3) and (4) of Directive 2003/54/EC under the following conditions:

- (a) the investment must enhance competition in electricity supply;
- (b) the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted;
- (c) the interconnector 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 interconnector will be built;
- (d) charges are levied on users of that interconnector;
- (e) since the partial market opening referred to in Article 19 of Directive 96/92/EC, no part of the capital or operating costs of the interconnector has been recovered from any component of charges made for the use of transmission or distribution systems linked by the interconnector;
- (f) the exemption is not to the detriment of competition or the effective functioning of the internal electricity market, or the efficient functioning of the regulated system to which the interconnector is linked.

(2) Paragraph 1 shall apply also, in exceptional cases, to alternating current interconnectors provided that the costs and risks of the investment in question are particularly high when compared with the costs and risks normally incurred when connecting two neighbouring national transmission systems by an alternating current interconnector.

(3) Paragraph 1 shall apply also to significant increases of capacity in existing interconnectors.

(4) (a) The regulatory authority may, on a case by case basis, decide on the exemption referred to in paragraphs 1 and 2. However, Member States may provide that the regulatory authorities shall submit, for formal decision, to the relevant body in the Member State its opinion on the request for an exemption. This opinion shall be published together with the decision.

(b) (i) The exemption may cover all or part of the capacity of the new interconnector, or of the existing interconnector with significantly increased capacity.

ii) In deciding to grant an exemption, consideration shall be given, on a case by case basis, to the need to impose conditions regarding the duration of the exemption and non discriminatory access to the interconnector.

(iii) When deciding on the conditions in (i) and (ii) account shall, in particular, be taken of the additional capacity to be built, the expected time horizon of the project and national circumstances.

(c) When granting an exemption the relevant authority may approve or fix the rules and/or mechanisms on the management and allocation of capacity.

(d) The exemption decision, including any conditions referred to in (b), shall be duly reasoned and published.

(e) Any exemption decision shall be taken after consultation with other Member States or regulatory authorities concerned.

5. The exemption decision shall be notified, without delay, by the competent authority to the Commission, together with all the information relevant to the decision. This information may be submitted to the Commission in aggregate form, enabling the Commission to reach a well-founded decision.

In particular, the information shall contain:

- the detailed reasons on the basis of which the regulatory authority, or Member State, granted the exemption, including the financial information justifying the need for the exemption;

- the analysis undertaken of the effect on competition and the effective functioning of the internal electricity market resulting from the grant of the exemption;
- the reasons for the time period and the share of the total capacity of the interconnector in question for which the exemption is granted;
- the result of the consultation with the Member States or regulatory authorities concerned;

Within two months after receiving a notification, the Commission may request that the regulatory authority or the Member State concerned amend or withdraw the decision to grant an exemption. The two months period may be extended by one additional month where additional information is sought by the Commission.

If the regulatory authority or Member State concerned does not comply with the request within a period of four weeks, a final decision shall be taken in accordance with the procedure referred to in Article 13(3).

The Commission shall preserve the confidentiality of commercially sensitive information.

Regulation

Article 6 General principles of congestion management

(6) Any revenues resulting from the allocation of interconnection shall be used for one or more of the following purposes:

- (a) Guaranteeing the actual availability of the allocated capacity;
- (b) Network investments maintaining or increasing interconnection capacities;
- (c) As an income to be taken into account by regulatory authorities when approving the methodology for calculating network tariffs, and/or in assessing whether tariffs should be modified.

Directive

Article 20 Third Party Access

(1) Member States shall ensure the implementation of a system of third party access to the transmission and distribution systems based on published tariffs, applicable to all

eligible customers and applied objectively and without discrimination between system users. Member States shall ensure that these tariffs, or the methodologies underlying their calculation, are approved prior to their entry into force in accordance with Article 23 and that these tariffs, and the methodologies — where only methodologies are approved — are published prior to their entry into force.

(2) The operator of a transmission or distribution system may refuse access where it lacks the necessary capacity. Duly substantiated reasons must be given for such refusal, in particular having regard to Article 3. Member States shall ensure, where appropriate and when refusal of access takes place, that the transmission or distribution system operator provides relevant information on measures that would be necessary to reinforce the network. The party requesting such information may be charged a reasonable fee reflecting the cost of providing such information.

Article 23 Regulatory authorities

(2) The regulatory authorities shall be responsible for fixing or approving, prior to their entry into force, at least the methodologies used to calculate or establish the terms and conditions for:

- (a) connection and access to national networks, including transmission and distribution tariffs. These tariffs, or methodologies, shall allow the necessary investments in the networks to be carried out in a manner allowing these investments to ensure the viability of the networks;
- (b) the provision of balancing services.

(3) Notwithstanding paragraph 2, Member States may provide that the regulatory authorities shall submit, for formal decision, to the relevant body in the Member State the tariffs or at least the methodologies referred to in that paragraph as well as the modifications in paragraph 4. The relevant body shall, in such a case, have the power to either approve or reject a draft decision submitted by the regulatory authority.

These tariffs or the methodologies or modifications thereto shall be published together with the decision on formal adoption. Any formal rejection of a draft decision shall also be published, including its justification.

(4) Regulatory authorities shall have the authority to require transmission and distribution system operators, if necessary, to modify the terms and conditions, tariffs, rules, mechanisms and methodologies referred to in paragraphs 1, 2 and 3, to ensure that they are proportionate and applied in a non-discriminatory manner.