Draft Explanatory note of DG Energy & Transport on Article 3 "Tariffs for access to the networks" of Regulation (EC) No 1775/2005 of the European Parliament and of the Council of 28 September 2005 on conditions for access to the natural gas transmission networks

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1. INTRODUCTION

(1) On 28 September 2005, the European Parliament and the Council adopted Regulation (EC) No 1775/2005 on conditions for access to the natural gas transmission networks (OJ L 289 of 3.11.2005, page 1). According to its Article 17, the Regulation enters into force on the 20th day following its publication, i.e. 23 November 2005 and shall apply from 1 July 2006.

(2) With a view to ensuring consistent application of the provisions of the Regulation, in particular on the matter of tariffs for access to the networks, the Commission services of DG Energy & Transport issue this document, which intends to provide explanatory comments on Article 3 of the said Regulation.

(3) At first, however, the relevant provisions of Directive 2003/55/EC are set out, in order to provide the background against which Article 3 of the Regulation has to be seen.

2. THE MATTER OF TARIFFS IN THE SECOND INTERNAL GAS MARKET DIRECTIVE AND THE REGULATION ON ACCESS CONDITIONS TO THE GAS TRANSMISSION NETWORK

(4) The core provision of the Directive with respect to tariffs is Article 18(1):

Article 18(1)

Member States shall ensure the implementation of a system of third party access to the transmission and distribution system, and LNG facilities based on published tariffs, applicable to all eligible customers, including supply undertakings, and applied objectively and without discrimination between system users. Member States shall ensure that these tariffs, or the methodologies underlying their calculation shall be approved prior to their entry into force by a regulatory authority referred to in Article 25(1) and that these tariffs — and the methodologies, where only methodologies are approved — are published prior to their entry into force.

(5) Tariffs and/or the methodology by which they are calculated (or derived from) have to be published prior to their entry into force and must be applicable to all system users on a non-discriminatory basis. In the case where market-based mechanisms are used to determine the cost of access their methodologies should be published. There is no element of negotiation involved anymore. System users must be able to accurately anticipate the costs incurred from using the system, i.e. enjoying a transportation service offered by the TSO. This also necessitates a sufficiently long time period between publication and entry into force of tariffs, as otherwise system users might not be able to assess the economic impact of tariffs.[1]

(6) It also follows from the article that there is no arbitrary element in the application of tariffs anymore, since they have to be objectively applied. There must not be any differences anymore in terms of tariff applications. Discounts or any other special treatment is not allowed anymore. The prohibition of discrimination requires that comparable situations are not treated differently, unless such treatment is objectively justified on the basis of differences in service levels and/or costs.

(7) Furthermore, the Commission services take the view that overall compliance with the provisions of the Regulation as a piece of supplementary legislation to Directive 2003/55/EC must be ensured by the regulatory authorities established by Article 25(1) of this Directive and must be seen against its overall objective, namely to establish a well functioning internal market for gas implying a free and unimpeded flow of natural gas across the EU internal market.

2.1. Non-discrimination

(8) Article 18(1) excludes any discrimination between system users accruing from the application of tariffs and/or the use of market based arrangements. This has a number of important consequences: Neither size, nor relation to TSO (i.e. whether they are a related undertaking), nor portfolio considerations in the case of large system users must affect the tariffs. Tariffs for identical services offered by individual TSOs should be identical. The tariffs should be designed with the aim of avoiding any structural

[1] This goes even more in the case of regulated tariff methodologies (cf paragraph 15)

cross-subsidy between transit and domestic transport. Methodologies, which take into account the incremental costs of funding investments in certain parts of the transmission system cannot be seen as a form of cross-subsidy though. Tariffs must be the same for the same service for all system users. This requires a system, where system users contract and pay the same tariff for capacity at entry and exit points irrespective of their size, their relation to the TSO or their portfolio.

(9) While distance of transportation should not principally be excluded as a factor for tariff setting, it should only be taken into account if

- a natural gas grid is not sufficiently meshed,
- gas transit flows are limited to point-to-point transports
- there is a threat of cross-subsidisation between different network users (pipe-in-pipe transports).

The reasons for applying distance as a factor have to be justified to the relevant regulatory authority. If the relevant national regulatory authority does not consider them justified, they must not be taken into account as a factor for tariff setting.

(10) Where the natural gas grid is sufficiently meshed and the TSO is capable of using the synergies between different flows and interruptible transportation contracts, distance of transportation shall not be a significant factor for deriving tariffs. Otherwise, in a sufficiently meshed system involving distance related elements (tariffs based on the contracted transaction), a large user (incumbent) would optimise transportation tariffs to be paid with a view to keeping the distances as short as possible. With a number of entry and exit points, where the gas is fed into the system and taken off from the system on his behalf, such a large user would enjoy considerable competitive advantages vis-à-vis any newcomer by such an optimisation of transport distances. This phenomenon is usually called the portfolio effect.

(11) Opposed to the incumbent system user, a newcomer with a small portfolio of supply sources and customers would need to stick to the contractual paths, although it is, at the end of the day, left to the transmission system operator, whether the gas is actually physically transported along the contractual paths or not. As a consequence, a newcomer would be disadvantaged in two respects[2]: First, he might need to pay for something which in reality is not delivered (contractual path does not equal the transportation path) and which could only be charged due to the fact that gas transportation is a natural monopoly[3], and second, he would not dispose of the optimisation options available to the incumbent system user and which only accrue from the fact that the incumbent usually enjoyed a monopolistic supply situation over decades.

(12) Thus, the most suitable possibility to ensure a level playing field and to enable competition to develop would be an entry-exit system, where the price for the capacity

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2 This goes notwithstanding the fact that in the case of unidirectional gas flows in an un-meshed system cast-based tariffs would be the same, no matter whether they are conceived under an entry-exit or distance-related system.

3 Putting aside very rare exceptions, which would not put in question the general truth of this statement

at the entry and exit points would be the same for all network users having contracted capacity at these entry and exit points, and, would only reflect the relevant share of costs incurred by transportation. Optimisation effects accruing from the different portfolios (various entry and exit points) should be undertaken by the TSO responding to the bookings. They would be reflected in the tariffs and allow all system users to benefit from them in a non-discriminatory and objective manner.

2.2. Tariff setting

(13) The Directive allows two ways of tariff setting:

(14) The regulatory authority shall approve tariffs: this could mean that either the TSO or the regulator actually sets up tariffs, but the tariffs would require approval by the regulator in any case. An exception to this rule is established by Art 25(3), pursuant to which "a relevant body" of the Member State concerned (usually the Ministry) shall take a formal decision on the tariffs.

(15) Alternatively, the TSO may calculate the tariffs on the basis of a methodology approved by the regulatory authority or in line with Art 25(3)[4]. In case methodologies are approved by the relevant regulatory authorities, the TSO must in any case provide full transparency on the calculation respectively on the methodology for the regulatory authority and the regulator must be in a position to verify whether the methodology has been applied correctly and require changes, if necessary, before tariffs enter into force.

(16) In either case, approval and publication of tariffs or the methodologies to calculate them is mandatory prior to their entry into force. TSO should provide reasonable notice to system users of changes in tariffs. It is worth noting that in the case of approved methodologies the period between their publication and their entry into force should be longer than in the case of tariffs, since it is thought to require more time for users to identify the economic consequences resulting from the application of methodologies than this may be the case in the event of approved tariffs.

(17) It is important to stress that the Directive does not make any differences with respect to the quality or the outcome of the procedure. No matter which procedure is applied, the outcome, i.e. the results must be the same. The reason for introducing the alternative option to approve the methodology used to calculate the tariffs rather than tariffs themselves must be seen against the background that in some Member States calculating tariffs by the regulator may overburden the resources of the relevant national regulatory authority due to the number of companies concerned. Another reason is that the TSO may operate under a revenue cap price control and therefore require the flexibility to adjust its tariffs around this to reflect costs and also to deal with under- or over-recoveries of revenue.

(18) Effective trade across various TSO networks including cross border trade excludes "pancaking" of transactions costs and transportation fees, which otherwise would result in barriers to trade and thus restrict competition. In the event that pancaking occurs, effective and efficient solutions should be developed and applied. The risk of

[4] See also recital 16 of the Directive.

pancaking could also be alleviated by efficient inter-TSO co-operation finally resulting in a one-stop-shop.

2.3. Cost base of tariffs

(19) Although there are no provisions defining explicitly the cost base of the tariffs, it is obvious from the requirement of non-discrimination that tariffs, in order to comply with this requirement, have to be based on actual costs incurred insofar as such costs correspond to those of an efficient and structurally comparable network operator, i.e. have to be cost-reflective. Otherwise, they may entail undue monopoly profits and would in the event of a company holding a TSO and a supply branch implicitly create a competitive advantage of the supply branch of this company, which could offer gas prices subsidised by internal transfers from the TSO to the supply branch, which actually have to be considered monopoly profits. Other reasons for cost based tariffs can be objectivity, allocative efficiency and promoting market integration.

(20) The provisions of the Directive clearly aim at providing "efficient and non-discriminatory access to the system". Among other things, "efficient access" would presuppose access tariffs that are not unduly high, but reflect the underlying efficiently incurred costs. Unduly high tariffs, which do not reflect the underlying costs could easily turn out to act as a barrier to market entry for new market participants and could thus restrict competition. They would also not allow being "objectively applied" as required by Article 18 of the Directive, since the only objective basis for access tariffs to the gas networks are the underlying costs.

(21) There can be no doubt that the overall objective and the very nature of the tariffs is to exclude discrimination accruing from the application of tariffs. The Directive has acknowledged this at several occasions[5]. In particular, in the case of vertically integrated companies holding both a supply branch and a TSO[6] the risks of market dominance and predatory behaviour addressed by Recital 2 of the Directive would otherwise remain – to the detriment of competing suppliers and the proper functioning of the market.

(22) The challenge now is to establish non-discriminatory transportation (and distribution) tariffs applicable to all users of the natural gas network. Whereas the portfolio effect (see above) could generally be offset by an entry-exit system, the continuing existence of companies holding both supply and network affiliates as a heritage of the past advocate tariffs which are based on costs incurred by the relevant service, i.e. transportation. Only cost-based or cost-reflective tariffs would deny a further competitive advantage of the incumbent supplier vis-à-vis its competitor, as long as the incumbent supplier belongs to the same mother company as the network operator.

(23) Article 25(2)a of Directive 2003/55/EC allows further insight in the nature of tariffs as established by the Directive. They *"shall allow the necessary investments in the network to be carried out in a manner allowing these investments to ensure the viability of the networks"*. This means that regulatory authorities in fixing or

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5 See recitals 2, 16 and 22 of the Directive.

6 This is usually the case on the European gas market bearing in mind the fact that just a little bit more than five years ago the market was clearly dominated by various supply monopolies combined and underpinned by the respective network assets

approving the tariffs or the methodologies to calculate and establish them have to take account of investments preserving the technical viability of the networks. In that, the Directive defines – albeit to a limited extent – the cost base to be used when it comes to setting up tariffs.

3. THE REGULATION ON ACCESS CONDITIONS AND ITS IMPACT ON THE MATTER OF TARIFFS

3.1. Relevant provisions

(24) In the following, the impact of the relevant provisions of Regulation (EC) 1775/2005 of the European Parliament and of the Council on conditions for access to the natural gas transmission networks (in the following: the Regulation) will be explored.

(25) Pursuant to Article 1 ("Subject matter and scope"), the Regulation

> *"… aims at setting non-discriminatory rules for access conditions to natural gas transmission systems…"*

This means that the scope of the Regulation in practice depends on the definition of "transmission" which is provided in Article 2(1), point 1 and reads

> *"'Transmission' means the transport of natural gas through a network, which mainly contains high pressure pipelines, other than an upstream pipeline network and other than the part of high pressure pipelines primarily used in the context of local distribution of natural gas, with a view to its delivery to customers, but not including supply;"*

(26) As a consequence, the concept of transmission in the Regulation encompasses all high pressure pipelines, unless they are used for production or processing of gas[7] or are primarily used in the context of local distribution of natural gas, with a view to its delivery to customers, i.e. are part of a local distribution system. The scope of the Regulation is therefore not limited to cross-border trade, but also includes high-pressure pipeline systems operating at regional scale.[8]

(27) Article 3 of the Regulation deals with "Tariffs for access to networks" and represents the core provision in this respect. It reads:

1. Tariffs, or the methodologies used to calculate them, applied by transmission system operators and approved by the regulatory authorities pursuant to Article 25(2) of Directive 2003/55/EC, as well as tariffs published pursuant to Article 18(1) of that Directive, shall be transparent, take into account the need for system integrity and its improvement and reflect actual costs incurred, insofar as such costs correspond to those of an efficient and structurally comparable

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[7] See the definition of "upstream pipeline network" in Directive 2003/55/EC, which pursuant to Article 2(2) of the Regulation is also applied in the Regulation.

[8] In theory, Directive 2003/55/EC would allow regional transmission pipelines to be covered by the definition of "distribution" contained in the Directive (see Article 2, point 5 of Directive 2003/55/EC). According to this definition, "distribution" means the "transport of natural gas through local or regional pipeline networks…" The definition of "transmission" used in the Regulation does not allow such an approach.

network operator and are transparent, whilst including appropriate return on investments, and where appropriate taking account of the benchmarking of tariffs by the regulatory authorities. Tariffs, or the methodologies used to calculate them, shall be applied in a non-discriminatory manner.

Member States may decide that tariffs may also be determined through market-based arrangements, such as auctions, provided that such arrangements and the revenues arising therefrom are approved by the regulatory authority.

Tariffs, or the methodologies used to calculate them, shall facilitate efficient gas trade and competition, while at the same time avoiding cross-subsidies between network users and providing incentives for investment and maintaining or creating interoperability for transmission networks.

2. Tariffs for network access shall not restrict market liquidity nor distort trade across borders of different transmission systems. Where differences in tariff structures or balancing mechanisms would hamper trade across transmission systems, and notwithstanding Article 25(2) of Directive 2003/55/EC, transmission system operators shall, in close cooperation with the relevant national authorities, actively pursue convergence of tariff structures and charging principles including in relation to balancing.

(28) Article 3 of the Regulation provides a direct reference to Article 25(2) and Article 18(1) of the Internal Gas Market Directive. By that, it underlines and spells out the principles laid down in the Directive on tariffs respectively the methodologies used to calculate the tariffs. Against this background, it is important to note that the provisions of Article 3(2) are without prejudice to Article 25(2) of Directive 2003/55/EC, which establishes the duty and power of regulatory authorities to fix or approve the tariffs in question. This is also confirmed by the 1st sentence of Article 3(1). The role assigned to TSO by Article 3(2) does not restrict the responsibility of regulators, but imposes an additional duty on TSOs to act *"in close cooperation with the relevant national authorities"*[9].

3.2. Qualitative Requirements of tariffs

3.2.1. Transparency

(29) Tariffs and the methodologies to calculate them must be ***transparent*** from the point of view of the user in the sense that they have to be clear and obvious for the user including their components (e.g. cm/h/yr, system service etc) allowing him to establish the price of the respective service and thus the costs he incurs by enjoying the service. In the event that tariff methodologies, but not the tariffs are approved by the regulator, the tariff methodologies have to provide a level of transparency allowing systems user to establish the actual tariffs for the respective services.

(30) The Commission services take the view that the transparency requirement of Article 3 of Regulation 1775/2005 has ideally to be understood to encompass transparency to the regulator on how the tariffs are established and/or how the methodology to calculate them is derived, as long as it complies with other legal requirements.

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[9] For further explanation, see chapter 3.2.10

3.2.2. System integrity

(31) Tariffs have to take into account ***system integrity*** as defined by Article 2(9)[10] of the Regulation and its improvement: this provision just reflects the need to maintain a well functioning system. In addition, however, also costs accruing from the solution of problems related to system integrity that are assessed to be efficient and reasonable by the relevant national regulatory authority should be recovered by tariffs.

(32) An entry-exit capacity system would be particularly beneficial to the introduction of competition on the European market, a matter, which has been extensively discussed at several occasions[11].

(33) From the point of view of the Commission services, the reference to system integrity in Article 3 of the Regulation would justify incorporating the needs to sort out problems relating to physically congested points accruing from the introduction of an entry-exit capacity system. In other words: investments with a view to alleviating physical congestion at certain points[12] of a given network without generally increasing the overall capacity of entry and exit points of the system concerned, but improving its overall performance by eliminating the said physical congestion could be taken into account in tariff settings. Such investments would allow competition better to develop and eliminate hindrances in that respect. They are supposed to de-bottleneck the system thus enabling more efficient capacity trading and competition, reducing balancing and/or exit zones, exploiting short-term market opportunities etc.

3.2.3. Cost basis

(34) Pursuant to the Regulation, tariffs shall reflect actual **costs** incurred, insofar as such costs correspond to those of an efficient and structurally comparable network operator[13]. Herewith, the Regulation reflects the principle of cost-reflectiveness as laid down in the Directive. However, contrary to the directive, the Regulation also defines the cost base that would qualify for being taken into account for the design of the tariffs.

(35) Only those costs must be taken into account that incur from an efficient and structurally comparable network operator. Cost transparency entails the publication of at elast the main summary economic data of the networks, e.g. the regulatory asset base, depreciation, operational costs and cost of capital. Costs incurred by inefficient operations or not related to network operations would not qualify as the relevant cost base to establish tariffs. In that respect, the question may arise what ought to be considered an efficient operator. The answers to this question may be left to the

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10 Article 2(9) reads: "system integrity means any situation in respect of a transmission network including necessary transmission facilities in which the pressure and the quality of the natural gas remain within the minimum and maximum limits laid down by the transmission system operator, so that the transmission of natural gas is guaranteed from a technical standpoint;"

11 For instance, at several meetings of the Madrid Forum.

12 These points are defined by point 3.2(e) of the annex of Regulation 1775/2005 as *"all essential points within the network of a given transmission system operator including points connecting to gas hubs. All points are considered essential which, based on experience, are likely to experience physical congestion."*

13 If relevant data from a structurally comparable TSO with respect to a particular cost component is not available, other relevant benchmarks might be used.

discretionary of regulators, which may take into account relevant findings at national and international level. They also may establish criteria to define structurally comparable network operators.

(36) The costs underpinning the tariffs have to be transparent (see above). Cost transparency entails the publication of at least the main summary economic data of the networks, e.g. the regulatory asset base, depreciation, operational costs and costs of capital. Furthermore, it has to be made transparent what costs and what cost allocations qualify as an appropriate base for tariffs compatible with the requirements of the Regulation bearing in mind that they must only be incurred by an efficient and structurally comparable network operator. This provision clearly constitutes a clarification of the relevant provisions of the Gas Directive that only outlines the nature of tariffs without giving any qualitative indications. The Regulation defines the cost base, thereby supplementing the Gas Directive by a very important element.

(37) The Regulation requires tariffs to also include an appropriate **return on investments**. While on the one hand, transmission networks are considered a natural monopoly and consequently are subject to regulation, it is clear on the other hand that investments have to be rewarded. The respective return, however, must be commensurate with the risk involved in the investment and must not be used in a manner distorting the competitive part of the gas business, i.e. the supply. This goes without prejudice to Article 9(2)c of the Directive, according to which the effective decision making rights of the transmission system operator should not prevent the existence of appropriate coordination mechanisms to ensure that the economic and management supervision rights of the parent company in respect of return on assets regulated indirectly in accordance with Article 25(2) in a subsidiary are protected.

3.2.4. Benchmarking as tariff setting principle

(38) While the relevant provisions of the Directive and the Regulation imply cost reflective tariffs, the Regulation allows, *"where appropriate taking account of the benchmarking of tariffs by the regulatory authorities"*. This means that the Regulation does not acknowledge benchmarking as a principle equally valid for tariff setting as the cost-based approach, but restricts its application to certain circumstances. This fact is constituted by the term "where appropriate".

(39) This raises the question of the scope of the term "where appropriate", i.e. what is the scope of the application of the benchmarking exercise when it comes to tariff setting. In this respect, recital 7 of the Regulation sheds light on when the Regulation considers the application of benchmarking as an additional element for setting up tariffs appropriate. Recital 7 reads:

> *In calculating tariffs for access to networks it is important to take account of actual costs incurred, insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent, as well as of the need to provide appropriate return on investments and incentives to construct new infrastructure. In this respect, and in particular if effective pipeline-to-pipeline competition exists, the benchmarking of tariffs by the regulatory authorities will be a relevant consideration.*

(40) Against this background, it is safe to say that

– the actual costs incurred insofar as such costs correspond to those of an efficient and structurally comparable network operator

– the need to provide appropriate return on investments and

– incentives to construct new infrastructure

can be made subject to a benchmarking exercise. However, this does not mean, for example, that the actual costs incurred "insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent" should not be established or identified by the relevant regulatory authority. It just means that the benchmarking of tariffs (which are established on the basis of those actual costs incurred) will be a relevant consideration. In the view of the Commission services, "a relevant consideration" represents a consideration that may or may not influence the overall outcome of the tariff setting, but cannot replace it.

(41) Recital 7 also highlights a specific case, where the benchmarking of tariffs by the regulatory authorities will be a relevant consideration, namely "if effective pipeline-to-pipeline competition exists". Regulators are thought to develop criteria allowing them to determine the existence of "effective pipeline-to-pipeline competition". These criteria should at least take into account that competing systems imply a real choice of the user which system to use. When developing and applying the criteria, national regulatory authorities of adjacent Member States should cooperate, in order to ensure a consistent and compatible approach across the Member States concerned.

(42) In the event that benchmarking of tariffs is applied, the tariffs emerging may deviate from those that would accrue from a pure cost-based approach. Bearing in mind that cost-based tariffs might be best to promote the underlying objectives of the Regulation and Directive 2003/55/EC, such an approach seems to be justified, if these objectives are thought to be better achieved by tariffs emerging from benchmarking. The relevant decision should be left to the discretionary of the relevant national regulatory authority.

(43) As a consequence, the Regulation does clearly not introduce the possibility of benchmarking as an equally eligible option between a cost reflective and a benchmark approach, but only as a complementary element to the cost-based tariff setting approach, which can be applied in certain circumstances. This means above all that benchmarking tariffs with a view to establishing them is without prejudice to the general principle of Article 3 of the Regulation, i.e. tariffs shall reflect those costs that are incurred by an efficient operator. It also means that benchmarking is not mandatory, but an admitted option "where appropriate", i.e. in certain circumstances. Against this background, the Commission services take the view that benchmarking can be used as an element complementing the cost-based tariff setting approach in certain circumstances.

(44) Benchmarking in relation to setting up tariffs complying with the Regulation must be carried out by the regulatory authorities (see recital 6) in charge of tariff setting or approving tariffs or the methodologies to calculate them. It cannot be done by the network operators just passing the results of the benchmarking exercise to the regulators. The reason for this provision is obvious: regulatory authorities, which pursuant to Article 25(1) of the Directive must be wholly independent of the interests

of the gas industry, would be in the best position to carry out a benchmarking exercise based on objective and relevant criteria supposed to deliver reliable and objective results.

(45) The Regulation does not require restricting the benchmarking to the national level. It is left to the regulators to decide on the appropriate references, which are to be found at national and/or international level.

(46) The Regulation also acknowledges the need that tariffs should bring about incentives to construct new infrastructure. Additional revenues accruing from those tariffs would not distort competition as long as they enable the construction of new infrastructure. The way how tariffs could provide the required incentives for the construction of new infrastructure is left to the regulators.

3.2.5. Tariffs set by market-based arrangements

(47) The Regulation allows tariffs to be determined by market-based arrangements such as auctions[14]. It is obvious that such kind of tariffs would not necessarily be linked to the underlying costs of the transportation service. However, it would be up to the regulators to decide on applying these arrangements and on how the revenues arising from them should be used. Revenues from auctions exceeding those of an efficient operator could, for instance, be recycled back to network users on a non-discriminatory basis.

3.2.6. Tariffs and competition

(48) The Regulation acknowledges the role attributed to tariffs and methodologies used to calculate them with respect to competition. Consequently, they shall

- facilitate efficient gas trade and competition: this means tariffs shall not be based on specific transactions (e.g. distance based), but shall be designed in a manner which facilitates capacity trading, exploiting short notice market opportunities and quickly reacting to market developments. Entry-exit tariff systems would be considered to represent a necessary (but not necessarily sufficient) prerequisite of this requirement of the Regulation, while all other tariff systems, subject to detailed examination, may not be considered compatible in this respect.

- avoid cross-subsidies between network users: cross subsidies for network users would not provide a level playing field for competition, since some users would pay less than the costs of the service they enjoy to the detriment of other users paying more than the costs of their transportation service would actually require. As a consequence, the level of competition to develop may vary depending on the level of cross subsidies involved. For this reason, postage stamp systems in large transmission systems, which per definition would result in the same level of transportation costs while transporting gas over long distances and irrespective of the entry and exit points contracted and thus involve cross subsidies between system users subject to detailed examination of the specific conditions, may not be considered compatible with the Regulation.

[14] See Article 3(1), 2nd subparagraph

- The stipulation to avoid cross subsidies may also be considered as an indication that entry-exit systems with specific tariffs, such as backhaul and short haul tariffs, are needed.

3.2.7. Interoperability

(49) According to the Regulation, tariffs also have a role to play in maintaining or creating interoperability. Albeit not defined in the Regulation, the term "interoperability" may be considered as

> *the technical possibility to ensure safe flow of natural gas from a pipeline network to another further downstream to the burner tip of the consumer, possibly built with different technical specifications and/or operated by a different operator. This includes corresponding problems related to operators in one country and gas quality problems occurring in a specific network or in interaction of two or more networks.*[15]

(50) By this, the Regulation acknowledges the fact that, unlike in the electricity sector, natural gas may vary in terms of quality and indeed is traded and supplied in a number of different qualities that are not freely exchangeable[16] without further measures. Furthermore, in order to establish an internal market with a free flow of gas, effective communication means between the different transmission systems must be ensured and have to comply with the requirements of a competitive market, to give only two examples. Such problems must not hinder the establishment of an internal market for gas and shall therefore be taken into account, where appropriate and necessary, when setting up or approving the transmission tariffs or the methodologies to calculate them. However, it goes without saying that regulators should employ a reasonable cost-benefit ratio in this respect, as otherwise effects endangering the overall objectives of the regulation may outweigh the positive achievements of an increased level of interoperability.

3.2.8. Liquidity

(51) The requirement for tariffs not to restrict market liquidity is actually reinforcing the general requirement for tariffs based on a reasonable return. Liquidity in the current context means liquidity of capacity on the primary market. The provision would imply tariffs to be designed in a manner that ensures both efficient use of capacity and offering as much capacity as technically possible to the market. Since, as set out above, tariffs have to be determined through the costs incurred, the rate of return on capital as established by the regulators must bring about sufficient incentives for the TSO to exploit the possibilities of his system with a view to offering the maximum level of capacity, just taking into account the requirements of system integrity. However, it is also obvious that a too high level of return would jeopardise the overall objective of the Regulation as well as the Directive, since they would increase obstacles to enter the market and therefore restrict competition. The Commission services taking into account the fact that the network is usually a natural monopoly take the view that the level of return must be commensurate to the risk involved. A

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15 GTE, Report on Interoperability

16 The most obvious example is high cal and low cal gas.

consistent and coherent approach of Regulators across the European market might be needed in this respect.

3.2.9. Convergence of tariff structures

(52) Article 3(2) also makes an explicit reference to trade across borders that must not be distorted. Therefore, the Commission services take the view that the methodologies of tarification used for network systems in different Member States/TSO systems take account of the need for harmonisation. What is meant by this provision is set out in more detail in the 2nd sentence of the paragraph. While national TSOs are likely to fall under the same regime with respect to tariffs, there is a specific need to address this issue in the context of cross-border trade, where differences in tariff structures may occur.

(53) Article 3(2) establishes the duty of TSOs, in close co-operation with the relevant national authorities, to cooperate among each other and pursue convergence of tariff structures. The Commission services take the view that the 2nd sentence of Article 3(2) imposes a duty upon TSOs in the event that the regulated tariffs to not achieve the objectives set out in Article 3(2) 2nd sentence.

(54) It is important to note that Article 3(2) refers to the relevant national authorities. This wording takes account of Article 25(3) of Directive 2003/55/EC, pursuant to which decisions of regulators on, among other things, tariffs can be made subject to approval from other national authorities. It is the understanding of the Commission services that only where

- differences in tariff structures would hamper trade across transmission systems and
- a Member State has relied on Article 25(3) of Directive 2003/55/EC – i.e. has not attributed exclusive responsibility on tariffs to the regulatory authorities established by Article 25(1) –

TSOs would have a duty to actively pursue convergence of tariff structures vis-à-vis the national bodies mentioned in Article 25(3). This will still require close co-operation with regulatory authorities established under Article 25(1) of Directive 2003/55/EC.

(55) In all other cases, in particular where regulatory authorities established under Article 25(1) of Directive 2003/55/EC have exclusive responsibility on, among other things, tariff setting, the need for TSOs "to actively pursue convergence of tariff structures" would be of no practical relevance, since regulatory authorities established under Article 25(1) of Directive 2003/55/EC are required to take these objectives fully into account when executing their duties under the Directive and the Regulation.