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COMMISSION STAFF WORKING PAPER

Commission staff working document on Article 22 of Directive 2003/55/EC concerning common rules for the internal market in natural gas and Article 7 of Regulation (EC) No 1228/2003 on conditions for access to the network for cross-border exchanges in electricity

- New Infrastructure Exemptions -

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– New Infrastructure Exemptions –

1. INTRODUCTION

1.1. Background

- (1) Directive No 2003/55/EC¹ and Regulation (EC) No 1228/2003² are based on the general principle of a regulated access regime to gas and electricity infrastructure.
- (2) Both legal acts however allow for exemptions from provisions enshrining this overall rule, as well as from provisions establishing ex ante and ex post tariff regulation. In particular, Article 22 (1) and (2) of the Gas Directive state that

1. "Major new gas infrastructures, i.e. interconnectors between Member States, LNG and storage facilities, may, upon request, be exempted from the provisions of Articles 18, 19, 20, and 25(2), (3) and (4) under the following conditions:

- (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.

2. "Paragraph 1 shall also apply to significant increases of capacity in existing infrastructures and to modifications of such infrastructures which enable the development of new sources of gas supply."

Article 7 (1) and (2) of the Electricity Regulation states that

¹ OJ L No 176 of 15.7.2003, page 57; hereinafter: "Gas Directive".

² OJ L No 176 of 15.7.2003, page 1; hereinafter: "Electricity Regulation".

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 conditions³:

- (f) the investment must enhance competition in electricity supply;
- (g) the level of risk attached to the investment is such that the investment *would not take place unless an exemption is granted*;
- (h) 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 which that interconnector will be built;
- (i) charges are levied on users of that interconnector;
- (j) 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;
- (k) the exemption is not to the detriment of the competition or the effective 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."

1.2. Objective of the Staff Working Document

- (3) This document provides information on the Commission's assessment of exemption decisions taken by national authorities⁴ according to Article 22 of the Gas Directive and Article 7 of the Electricity Regulation.
- (4) It explains the general framework and analyses the assessment criteria, the information to be provided by the relevant authorities and conditions that may be imposed.
- (5) The experience with granting exemptions for new major infrastructure has shown that the conditions of Article 22 of the Gas Directive and of Article 7 of the Electricity Regulation are not always sufficiently clear to the national authorities and market participants, in particular the interpretation of the assessment criteria, the information that needs to be submitted and the conditions that may be imposed to meet the criteria. The Commission services have therefore decided to revise the interpretative note

³ OJ L No 176 of 15.7.2003, page 37; hereinafter: "Electricity Directive".

⁴ On the competences for granting an exemption on national level Article 22 (3a) states that "*The regulatory authority referred to in Article 25 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*". The text therefore refers in general to the "national authority".

issued in 2004⁵, and replace it by the current one. Notably, the present document does not modify the general exemption policy regarding Article 7 of the Electricity Regulation and Article 22 of the Gas Directive but gives better guidance in the light of the practical experience gained since the publication of the previous note. The objective is to provide transparency and guidance to national authorities and market participants and to facilitate the procedures for assessing exemptions.

- (6) This document is not intended to restrict or change the criteria for awarding exemptions. Nor is this document intended to give an exhaustive interpretation of the various assessment criteria that are applied in the light of the facts and circumstances of each individual case.
- (7) The document is applicable to all types of infrastructure eligible for an exemption according to Article 22 of the Gas Directive and Article 7 of the Electricity Regulation, i.e. gas storage, gas interconnector pipelines, LNG terminals and new direct current electricity interconnectors⁶. The case for granting an exemption is not per se stronger for any type of eligible infrastructure but needs to be evaluated on a case by case basis according to the criteria of Article 22(1) of the Gas Directive and Article 7(1) of the Electricity Regulation.
- (8) The document does not provide guidance on the application of the Community competition rules to projects covered by the exemption procedure. The grant of an exemption is without prejudice to the application of the Community competition rules.

1.3. General policy on new investments

- (9) New infrastructure is essential to complete the internal energy market and to ensure effective competition. The Gas and Electricity Directives oblige transmission system operators (TSOs) to invest to meet reasonable market demand for transmission in order to ensure the long term ability of the system and to meet demand. The necessary investments should therefore be realised by the TSOs provided that the ensuing costs are adequately compensated for by regulated tariffs. Regulators have to provide tariff incentives and appropriate economic signals to encourage these investments.⁷
- (10) Exemptions are designed to allow for investments where the level of risk attached to the investment is such that the investment would not take place unless an exemption is granted. The relevant risks may take different forms (see chapter 2.4).
- (11) When assessing exemption requests national authorities have to strike a balance between the objectives of, on the one hand, promoting infrastructure investment and, on the other, ensuring competition through fair, non-discriminatory access to infrastructure which is one of the key principles of energy market liberalisation.

⁵ Note of DG TREN on Directive 2003/55/EC and Regulation 1228/2003 in the electricity and gas internal market concerning exemptions from certain provisions of the third party access regime, 30.1.2004.

⁶ On eligibility of infrastructure see later chapter 2.1.

⁷ See Commission staff working document on capacity allocation and congestion management for access to the natural gas transmission networks regulated under Article 5 of Regulation (EC) No 1775/2005, SEC(2007) 822, paragraph 9 and 15.

- (12) Based on the above considerations, the national authorities need to assess exemption requests for new major infrastructure on a case by case basis. It is the particular characteristics of the investment project and of the markets concerned that determine the need and the scope of a possible exemption. When assessing an exemption request, the national authority needs to investigate in detail the impact of the specific exemption on competition, security of supply and the functioning of the internal market. Moreover, the national authority should take into account the risk of creating a competitive distortion between regulated and exempted infrastructure. To ensure a consistent application of the exemption practice and to safeguard the wider European interest, the Commission reviews the national exemption decisions.
- (13) Any exemption is subject to the compliance with the conditions listed in Article 22 of the Gas Directive, respectively Article 7 of the Electricity Regulation. Compliance with the conditions is cumulative, so a trade-off is not possible. The competent authorities can however decide to impose conditions on the project so that it is compatible with the conditions listed in Article 22 of the Gas Directive or Article 7 of the Electricity Regulation.
- (14) The burden of proof to show that the necessary conditions are fulfilled lies with the applicant. This involves the requirement to provide all necessary documents to the Commission.
- (15) Regulators are encouraged to develop incentives for new investments within the framework of their regulated system. Any such investment incentives should be published and have to comply with the rules as described in the Gas and Electricity Directives and Regulations. Moreover, they should not discriminate but apply equally to similar types of infrastructure.
- (16) National authorities can grant exemptions in particular from two provisions in the legislation: from the third party access ("TPA") obligation in particular through the ex ante approval of the terms and conditions, including tariffs (Articles 18, 19, 25(2) and (3) of the Gas Directive and Articles 20, 23(2) and (3) of the Electricity Directive) and from the ex post regulation on terms and conditions including tariffs (Article 25(4) of the Gas Directive and Article 23(4) of the Electricity Directive).⁸ The exemption decisions however do not necessarily have to cover all obligations (full exemption) but can be limited to only some (partial exemption). Moreover, the exemption may be limited to a certain share of the overall capacity of the infrastructure investment.
- (17) Exemptions are an exception to the general rule of regulated TPA. Such exceptions have to be limited to what is strictly necessary to realise the investment and the scope of the exemptions has to be proportionate. Exemptions cannot be granted based on the argument that an investment needs to be protected from future changes in (third party access) regulation that may affect the value of the investment. To ensure the proportionality of an exemption, exemption decisions may include conditions ensuring the fulfilment of the assessment criteria as set out in Article 7(1) of the Electricity Regulation and Article 22(1) of the Gas Directive.

⁸ Regarding storage an exemption can be granted from negotiated Third Party Access, i.e. no exemption from ex ante approval of terms and conditions is needed.

- (18) Partial exemption may include the following elements:
- 18.1 Limiting the exemption to part of the infrastructure, i.e. less than 100% of the capacity. In this case, part of the capacity would fall under regulated TPA and the project promoters would be exempted from the TPA rules only for the other part of the capacity. Another example, for pipelines, is to grant an exemption for forward flows but not for backhaul capacity or reverse flow.
- 18.2 Limiting the exemption to parts of the regulatory TPA rules, e.g. demanding third party access but granting an exemption from rules on tariff setting (or the methods for calculating tariffs) and/or ex-post regulation of terms and conditions for TPA. This derogation can apply to 100% of the capacity or parts of it. Another example for a partial exemption is to exempt the project from only parts of the tariff related rules, e.g. by granting a higher rate of return.

Box 1: Examples of partial exemptions

There are some examples of partial exemptions for new major infrastructure. In the case of the two Italian LNG terminals in Rovigo and Brindisi, only 80% of the capacity was exempted. The remaining 20% is subject to regulated third party access.

In the case of the Balgzand-Bacton Line (BBL) transporting gas between the Netherlands and the UK, reverse flow nominations (i.e. in the direction from the United Kingdom to the Netherlands) were not exempted. The Commission imposed this condition stating that competition on the Dutch market would only be enhanced if fair and non-discriminatory access was available for such reverse flow nominations which could only be assured through regulated third party access.

- (19) Finally, for *electricity*, the infrastructure in question may merely be exempted from Article 6(6) of the Electricity Regulation which deals with the use of congestion management revenues. While the infrastructure in question would still have to comply with the congestion management guidelines the project promoter would not be obliged to use congestion revenues for the purposes set out in Article 6(6) of the Electricity Regulation. The regulator's right to intervene ex-post, as set out in 23(4), would consequently be constrained.
- (20) In any case, for gas pipelines and electricity cables the principles as set out in Articles 5 and 6 of the Gas⁹ and Electricity Regulations including their annexed guidelines must be respected. The application of congestion management and anti-hoarding procedures contributes to meeting both the competition and security criteria provided in Article 22 of the Gas Directive and Article 7 of the Electricity Regulation. This applies to both the exempted and non exempted part of the infrastructure.
- (21) Cross-border projects in particular require cooperation between national authorities with respect to the exemption application. Coordinating an exemption decision with

⁹ OJ L No 289 of 31.11.2005, page 1; hereinafter: "Gas Regulation".

authorities of neighbouring Member States should however be useful for any type of infrastructure, having in mind that also storage facilities and LNG terminals can have an impact on the competition and security of supply situation of other Member States. In this context both Article 7 paragraph 4(e) of the Electricity Regulation and Article 22 paragraph 3(e) of the Gas Directive require exemption decisions on interconnectors to be taken "after consultation with other Member States or regulatory authorities concerned". Such consultation should result in the exemption decisions for the whole project being coordinated. The consultation should include the exchange of relevant documentation and information justifying the need for the exemption and the results of the consultation with other affected authorities.

Box 2: Natural monopoly

When assessing an exemption request national authorities should consider to what extent a planned project would constitute a natural monopoly. In a situation of natural monopoly, there is no scope for building a competing infrastructure, be it for economic, technical or other reasons. As a general rule, the access regulation of an infrastructure should be stricter, the more it displays characteristics of a natural monopoly. The reason is that in this situation, market players have no choice to access or build alternative infrastructure so that they have to rely on the planned infrastructure to offer fair terms and conditions for access.

All other things being equal, the position of an infrastructure as natural monopoly weakens the case for an exemption because the exemption is likely to be detrimental to the objective of enhancing competition and to ensuring the effective functioning of the internal market.

2. CRITERIA FOR AWARDING AN EXEMPTION

2.1. Eligible type of infrastructure

Gas

- (22) With respect to the eligible type of gas infrastructure Article 22 (1) of the Gas Directive limits possible exemptions to "major new gas infrastructures, i.e. interconnectors between Member States, LNG and storage facilities". The scope of the covered types of infrastructure follows their definition in Article 2 (9), (11) and (17) of the Gas Directive. According to Article 22 (2) any "significant increase of capacity in existing infrastructure and modifications of such infrastructure" are eligible, provided such modifications "*enable the development of new sources of gas*".
- (23) A "major" piece of infrastructure is generally understood to be a project which involves high cost. It appears reasonable to relate the definition of "major" to the size of the market concerned and to relate it directly to the additional costs for the connected systems. The same is applicable for the requirement of a "significant" increase".

Electricity

- (24) For the electricity sector Article 7 (1) of the Electricity Regulation is in principle designed for "*new direct current interconnectors*". An interconnector is defined in Article 2 (1) of the Electricity Regulation. According to Article 7 (2) and (3), an exemption can also be granted "*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*" and to "*significant increases of capacity in existing interconnectors*".

2.2. Enhancement of security of supply (gas only)

Assessment criteria

- (25) It is considered that a new infrastructure enhances security of supply:
- 25.1 If it contributes to the diversification of supply to the relevant market, in particular by facilitating transport of gas from a new source of supply or by merely opening a new route of supply from an existing source of supply.
- 25.2 If it contributes to achieving the security of supply standards for household customers in the supply markets as defined in Article 4 (1) of Directive 2004/67/EC concerning measures to safeguard security of natural gas supply.¹⁰.
- (26) The more flexibility of supply an infrastructure project adds for bringing additional gas to a market in case of an emergency, the more it enhances security of supply. For example, the contribution to security of supply of LNG terminals could be greater than the contribution of gas pipelines as the former allow in principle for imports from a much wider choice of locations (depending on the underlying contracts). Another element of flexibility that may enhance (or in its absence diminish) security of supply is the degree of effectiveness of the project's anti-hoarding mechanism, or the reservation of part of the capacity for short-term contracts.
- (27) The larger the planned project compared to the market size, the greater – all things equal - the contribution to the security of supply.

Necessary information to be provided by the project developer and/or the national authority

- (28) To assess the infrastructure project's ability to meet the above mentioned requirements it is considered necessary that project developers and/or the national authority submit at least the following information:
- 28.1 A record of the (national or regional) markets that are intended to be supplied by the project including information on the project's ability to provide entry to and exit from these markets.
- 28.2 The current and forecasted supply and demand balance of the (national or regional) markets intended to be supplied by the project including the supply percentage for the relevant market that is expected to be covered by the project.

¹⁰ OJ L No 127 of 29.4.2004, page 92.

- 28.3 A justification for the project dimension (in terms of the total capacity) based on the supply and demand balance provided under point 28.2 above and on an assessment of capacity on existing supply routes including information on how the project ensures the meeting of effective demand of transport capacity to the (national or regional) markets intended to be supplied (e.g. via an open season procedure).

Box 3: Testing of market demand

As a general rule, project promoters are required to test market demand before they can obtain an exemption. The more a project enjoys a monopolistic position, the greater is the barrier for market entry and competition resulting from capacity scarcity and therefore the need to adjust the project size to market demand.

As a general rule, project promoters should take into account the capacity requests as apparent from the market test. It is only in certain circumstances e.g. due to geological, technical or legal constraints that capacity requests do not have to be fully taken into account. Other reasons that may justify that the results of the market test are not fully taken into account may be that customers have realistic possibilities of obtaining capacity in alternative pieces of infrastructure. The justification of these arguments needs to be assessed by the national regulator on a case by case basis.

Testing market demand is a crucial element to evaluate the riskiness of a project and to assess to what extent the planned project enhances competition and security of supply. Market demand is usually tested via so-called Open Season procedures, but other methods may be acceptable as well (e.g. network development plans).

In the case of the Nabucco pipeline, for example, the project promoters have committed to the regular testing of market demand by performing open season procedures, thus making available to third parties additional transportation capacity to meet the effective demand. The project promoters are in principle obliged to take into account all binding capacity requests originating from the open seasons provided that the sum of these requests adds up to at least 1 bcm/year.

- 28.4 The source of the electricity or gas, if possible by information on supply or transport contracts in the case the capacity of the infrastructure is allocated on a long term basis. The requirement is of less relevance in the case the capacity will be marketed through short term services.

Possible conditions to be imposed on the project

- (29) To ensure that a project enhances security of supply the national authority may impose, inter alia, one or more of the following conditions:
- 29.1 A requirement to test the market demand¹¹ and increase the total capacity offered adjusted to the demand indicated.

¹¹ See eg European Regulators for Electricity and Gas, Guidelines for Good Practice on Open Season Procedures, Ref: C06-GWG-29-05c (21 May

- 29.2 In the case of gas pipelines, a requirement to link the pipeline to other markets, for example by adding one or more entry/exit points to one or more markets along the pipeline.

2.3. Enhancement of competition

Assessment criteria

- (30) Article 22 of the Gas Directive and Article 7 of the Electricity Regulation require that the investment project enhances competition in gas or electricity supply and that the exemption is not detrimental to competition. While these two requirements are not identical (see below), they imply that the project must be pro-competitive and thus create benefits for consumers.
- (31) The enhancement of competition test in these provisions is a sui generis test. However, in the application of the test it is relevant to have regard to the principles developed under Articles 81 and Article 82 of the EC Treaty and the EC Merger Regulation.¹² This implies that likely negative effects and likely positive effects must be assessed and balanced.
- (32) Investment in infrastructure is likely to entail positive effects on competition through increased capacity. If - in the absence of the exemption - the project did not go ahead or had a smaller scale, an exemption triggering the investment would usually generate positive effects on competition. However, the grant of an exemption counteracts this effect to some extent in the cases where access to the exempted infrastructure is restricted which is in turn likely to restrict competition, in particular if the capacity is held by players with a significant degree of market power. The decisive question is whether on balance the project will enhance competition.
- (33) Exemption requests by dominant undertakings in markets served by the new infrastructure are likely to have the greatest potential for harming competition and therefore require particularly careful scrutiny. However, also exemption requests introduced by non-dominant undertakings may in certain circumstances have a negative effect on competition. This may be the case, in particular, where the undertakings requesting the exemption – individually or collectively – have a significant degree of market power or where the exemption might favour the market position of third parties that are either dominant or have a significant degree of market power. This could be the case, for example, where the exemption is requested by a company that has no supply interests, but capacity in the exempted infrastructure is or could be contracted on a long term basis by dominant suppliers.
- (34) If a dominant undertaking is the direct beneficiary of an exemption or could become an indirect beneficiary by booking important amounts of capacity with the direct beneficiary, a positive competition assessment is unlikely in the absence of conditions that effectively address the competition concerns. As a minimum, the exempted

2007), http://www.ergeg.org/portal/page/portal/ERGEG_HOME/ERGEG_DOCS/ERGEG_DOCUMENTS_NEW/GAS_FOCUS_GROUP/.

¹² Council Regulation (EC) 139 /2004 of January 20, 2004 on the control of concentrations between undertakings, OJ L No 24 of 29.1.2004, p. 1,

<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2004:024:0001:0022:EN:PDF>

investment must provide significantly increased opportunities for non-dominant competitors to enter the market(s) concerned or to expand their market position. This normally requires that the exemption beneficiary's discretion to allocate capacity in its infrastructure is limited, for example by means of a capacity cap. Moreover, any information flows from the operation of the exempted infrastructure to the supply branch of dominant undertakings with respect to third party behaviour may have to be restricted. The new infrastructure should have the effect of diluting the market power of the dominant undertaking(s). The share of capacity held by one or more dominant companies in the new infrastructure has to be significantly lower than its/their market share(s)¹³.

Box 4: Examples of capacity caps

In past cases, project promoters or regulatory authorities have proposed capacity caps to ensure that the exempted infrastructure would enhance competition.

In the case of the Dutch LNG terminal Gate, the national regulator required that the project promoters allocate at a maximum of 50% of the primary capacity to any party that holds a dominant position in the natural gas market. Notably, the project promoters did not plan to reserve any capacity for themselves since they were not active in the gas supply business.

In the case of the Nabucco gas pipeline, the Commission required that at a maximum 50% of the total exit capacity of the Austrian section of the pipeline be allocated to any undertaking that dominates one or more of the relevant upstream or downstream natural gas markets. To allow for some flexibility, the 50% cap could be exceeded if there was insufficient interest by third parties preventing the expansion of the pipeline. However, in this situation, the gas volume in excess of the 50% cap would have to be sold to the market in an open, transparent and non-discriminatory procedure.

In the case of the East-West-Cable between Ireland and the United Kingdom (Wales), the project promoters proposed to cap the capacity available to any one party at 70% and in the case of the incumbent Irish electricity supplier ESB to 40%. If this cap were reached the regulator would have to undertake a competition analysis before that party could purchase additional capacity.

- (35) The competition assessment has a strong forward-looking element since the implementation of a project generally takes time and since the requested duration of the exemption is often very long. It is therefore necessary to have regard to likely market developments. It is necessary to conduct an assessment of the probability and/or the degree of certainty of the forecasted competition effects.
- (36) An assessment of exemption requests requires a proper definition of the relevant market and a thorough analysis of the market structure. For the definition of the relevant market and the assessment of competitive effects, the competent authorities

¹³ See also the analysis of the effect of the exemption on competition in chapter 2.8 below. In application of that provision, negative repercussions of the exemption on other projects which would put competitors to the dominant undertaking(s) in a more favourable position need to be examined closely.

should apply analytical techniques that are consistent with those applied in competition cases at national and European level.¹⁴ They shall also take due account of findings in competition cases at national and European level on the market(s) concerned. The assessment typically involves:

- (a) A definition of the relevant product and geographical markets;
- (b) An analysis of the wholesale and retail market structure including market shares of the project developers and potential beneficiaries of capacity allocations as well as an evaluation of the market positions of their actual and potential competitors;
- (c) An analysis of effects on upstream and downstream markets;
- (d) An illustration of the capacity share of the proposed project in relation to the total capacity in the relevant market;
- (e) An analysis of the allocation of capacity to parties and third parties, including an analysis of the types of contracts to be concluded (short-term vs. long-term). Evidence of a market demand test normally helps to determine the interests of third parties in obtaining capacity.

Necessary information to be provided by the project developer and/or national authority

- (37) To assess whether a project enhances competition project developers and/or national authority should submit at least the following information:
 - 37.1 The ownership structure of the investment project;
 - 37.2 The applicants' views of the relevant markets affected by the exemption (including the relevant upstream and downstream markets and including both wholesale and retail markets);
 - 37.3 The market structure on each of these markets, including a description of the relevant market conditions and a determination of the market shares of the project developers and of their actual or potential customers, as well as the market position of their competitors and, where available, information on competing investment projects affecting the same markets;
 - 37.4 The way in which capacity is (to be) allocated including the result of any market demand test conducted by the project promoters or information on any market demand test which is planned;
 - 37.5 An assessment of the expected effects of the project on the markets affected;

¹⁴ The following notice provides relevant guidance: Commission Notice on the definition of the relevant market for the purposes of Community competition law, OJ C 372/5, 9 December 1997. The following guidelines provide useful analytical tools by way of analogy: Guidelines on the assessment of horizontal mergers under the Council regulation on the control of concentrations between undertakings, OJ C 31/5, 5 February 2004. Guidelines on the application of Article 81(3) of the Treaty; Commission Notice on Guidelines on vertical restraints, OJ 2000 C 291; Commission Notice on Guidelines on the application of Article 81 of the Treaty to horizontal cooperation agreements, OJ 2001 C 3.

- 37.6 Measures to prevent hoarding of capacity;
 - 37.7 Any other measures to ensure that the investment project enhances competition;
 - 37.8 Measures to support trading of secondary capacity.
- (38) The national authority should provide an assessment of the information mentioned above, based on the information provided by the project developer and the supplementary information already in its possession or collected for the purpose of assessing the exemption request.

Possible conditions to be imposed on the project

- (39) To ensure that the project enhances competition, the national authority may impose, among others, one or more of the following conditions:
- 39.1 A requirement to test market demand and to satisfy the interest expressed therein to the largest possible extent (see Box on Testing Market Demand) and to define a minimum size of the infrastructure to avoid excessive congestion rents.
 - 39.2 A limitation of the maximum percentage of capacity that can be allocated to an undertaking with significant market power in the relevant market(s). This condition can be combined with the requirement to release the capacity share or corresponding gas volumes exceeding the defined maximum percentage.
 - 39.3 A limitation of the validity of the exemption decision by making it conditional on the project starting operation within a certain time period. This measure avoids "exemption hoarding" which may lead to blocking of locations or routes for competing projects.
 - 39.4 A requirement to reserve capacity for short-term contracts to enable the development of a spot market. It may be considered that reservation of capacity for short-term trading is not fixed as a pre-defined percentage but ideally based on the respective market demand for short-term capacities indicated in a market demand evaluation. It has to be recognised that offering short-term products would typically have an impact on the project financing structure by reducing the predictability of long term revenues. Consequently the national authority would be required to take this effect into account when evaluating the risk of the project.
 - 39.5 Requirements on the ownership structure of, and the distribution of voting rights in, the corporate entity governing the exempted infrastructure including provisions in its by-laws and agreements between its shareholders; requirements regarding the independence of management, substantial financial or contractual relationships or information flows.
 - 39.6 Requirements to release a part of the gas delivered at the downstream market through the new infrastructure to other parties.
 - 39.7 A limitation of the exemption to a part of the capacity of the proposed investment.

2.4. Level of risk

Assessment criteria

- (40) The basic criterion regarding risk is that the investment would not take place unless an exemption is granted.
- (41) If the investment in infrastructure for gas or electricity is a sunk cost, two main risks determine the assessment: the risk of non-use of the investment and the risk of a change in costs and/or revenues in the future. The risk of non-use for the project developer is related to the risk of capacity users to ensure availability of upstream supply and downstream demand. This risk may also originate from changes in flows caused by changes elsewhere in the system. A change in costs and/or revenues can occur due to non-use or due to a change in the market situation (lower demand triggering a lower value for the infrastructure), contracts or access terms and conditions (in particular when there are multiple regulators involved in the approval of the access terms and conditions).
- (42) The risk of securing upstream supply for capacity users is relevant in particular for LNG terminals and gas pipelines whereby evidence that the upstream suppliers may require from infrastructure developers long-term transportation and transmission contracts to conclude supply contracts needs to be taken into account.

Box 5: Long term contracts

The construction of new major pieces of infrastructure is often linked to the conclusion of long term contracts for upstream supply and/or transport capacity. Such contracts are in principle a legitimate way for project promoters to reduce the economic risk of their investment. Moreover, producers often prefer to sell their energy in long-term contracts to hedge their investment risk for example in exploration or production facilities or in liquefaction in the case of LNG. Project promoters may therefore have little choice but to offer a certain share of long term contracts to attract sufficient supply.

It should be noted that long term contracts do not necessarily require the granting of an exemption but may in principle also be concluded for regulated infrastructure. Limitations on long term contracts may however originate from national legislation or from the application of competition law.

Where exemption requests include long term capacity reservation it is likely to be necessary to mitigate the foreclosure effect of such contracts in order to ensure that competition and security of supply are enhanced. In particular, it may be necessary to apply use-it-or-lose-it rules and to facilitate capacity trading on the secondary market.

- (43) The risk is lower the higher the likelihood is of the project in question to enjoy an unchallenged position in relation to the service it offers to participants in the markets. Indicators for this are, for example, the possibilities for competing investment projects being realised.

- (44) The level of risk would tend to be weaker where an integrated energy company builds a new piece of infrastructure. In the case of integrated companies including for example an established retail supply business, the downstream risk would appear to be reduced given their established customer base.
- (45) Risk mitigating measures need to be analysed, such as involving other parties and testing market demand to mitigate the risk of non-usage, or measures to create income stability and/or secure upstream supply through long-term and/or ship or pay contracts, which spread the risk over upstream and downstream markets. Such demand analysis allows for mitigating the project risk by increasing its ability to be contract-financed (see Box 3 on Testing Market Demand).
- (46) A greater likelihood of a monopoly position, all other things being equal, lowers the riskiness of the investment and thus reduces the need for an exemption.

Box 6: Risk assessment where a regulated and an exempted infrastructure are planned in parallel

A particular situation may arise where different project promoters envisage the construction of two similar infrastructure projects e.g. in terms of location, size and use, but one project is planned to be built as a regulated asset and the other requests an exemption is requested for the other. The plans for a regulated infrastructure would seem to indicate that the risk criterion is not fulfilled, i.e. that the level of risk attached to this type of project is not so high that it could be carried out only under an exemption.

If the regulated project goes ahead and the project promoters of the alternative project consider that market demand is still sufficient also to build their project, the case for an exemption may however be different. If the regulated project already satisfies a substantial part of the market demand, an additional project may indeed be considered riskier because it may be less certain that there is sufficient additional market demand to make the project profitable. Moreover, there would be no longer the risk that the exempted infrastructure would constitute a monopoly with potentially negative consequences for competition and security of supply.

Necessary information to be provided by the project developer and/or the national authority

- (47) To assess the level of risk linked to the project, project developers and/or national authorities should submit at least the following information:
- 47.1 An argumentation on why the investment would not take place without an exemption.
- 47.2 An assessment of the risk of non-use and an assessment of the ensuing risk of a change in revenues.
- 47.3 An assessment of the risk mitigating measures at the disposal of the project developers and the use of these measures for the project.

- (48) To assess the financial aspects linked to the project at least the following information should be submitted:
- 48.1 The estimated costs and revenues of the project, including the underlying assumptions and, if applicable, an analysis of uncertainties and probabilities:
- (a) Investment and operational costs;
 - (b) Revenues.
- 48.2 Key financial parameters for the project
- (c) Net Present Value;
 - (d) Earn-back period;
 - (e) Internal Rate of Return;
 - (f) Cost of capital/discount rate;
 - (g) Debt/Equity ratio (current and future financial structure);
 - (h) Debt coverage ratio
 - (i) Cost of debt;
 - (j) Cost of equity;
 - (k) Residual project value.
- 48.3 The financial risk compared to projects of comparable size, type of infrastructure etcetera, in particular regulated investment projects.
- 48.4 If relevant for the analysis of the financial parameters, obligatory accounting principles that apply in the Member State.
- 48.5 The effect on the financial structure and parameters in case the project were developed within the regulated system. This involves an analysis of the predominant cost structure in the relevant market and price effects on prices for final customers before and after the grant of the exemption.
- 48.6 An argumentation by the national authority on why it has decided to grant an exemption instead of applying investment incentives for the project within the regulated system. This would, in particular, address the question of why such incentives would not mitigate the risk sufficiently, e.g. create certainty with respect to utilisation and revenues of the project.
- (49) In case infrastructure projects are (partially) financed by grant support from the Member State(s) concerned or the European Community, this should be taken into account to the extent that the project was publicly funded, as this contributes to a reduction of the risk.

- (50) The assumptions underlying the risk attached to the investment should be evaluated by the national authority in an assessment independent from the project sponsor.
- (51) The applicant should provide evidence of compliance with the statements provided in the exemption by appropriate means such as information regarding (supply or other) contracts and agreements.

Possible conditions to be imposed on the project

- (52) To ensure consistence between the exemption granted and the level of risk linked to the project, the national authority may impose at least one or more of the following conditions:
 - 52.1 Limitation of the exemption duration: when determining the duration of the exemption, the following should be taken into consideration:
 - (a) Throughput contracts for terminals, duration of underlying transportation contracts for pipelines and cables, and/or upstream and downstream supply contracts;
 - (b) The level of risk assessed according to chapter 2.4 of this note; notably, the duration of the exemption does not have to correspond to the full length of the amortisation period. The exemption duration should be equal to or less than the expected period for cost recovery of the new infrastructure.
 - 52.2 Limitation of the capacity exempted from the requirement to provide TPA and reserved for own use of the project shareholders.

2.5. Ownership structure

- (53) Both Article 22, paragraph 1 (c) of the Gas Directive and Article 7, paragraph 1 (c) of the Electricity Regulation require the infrastructure to 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*".
- (54) The requirement makes clear that the portion of the interconnector that is exempt from price regulation should not have any of its costs underwritten through regulated transmission charges. The criterion aims at ensuring sufficient ring-fencing of non-regulated activities of TSOs.

2.6. Charge levy

- (55) Both Article 22(1)(d) of the Gas Directive and Article 7(1)(d) of the Electricity Regulation require "charges [for the use of the infrastructure] to be levied on users of that infrastructure."
- (56) As with the criterion on ownership structure, this criterion is aimed at sufficient ring-fencing of non-regulated activities of transmission systems operators if it is those which operate an exempted infrastructure.

- (57) It should also be noted that, in the case of an infrastructure operated by undertakings with a supply interest, there is a risk that transport charges are excessive to deter TPA. An integrated undertaking would not suffer from such excessive transport charges since they would increase the revenue of the transport branch in as much as they would decrease the revenue of the supply business.

2.7. Cost coverage from transmission or distributions charges (electricity only)

- (58) Article 7(1)(e) of the Electricity Regulation requires that "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".
- (59) This criterion effectively rules out any exemption of this type being applied to existing interconnectors.

2.8. Exemption should not be detrimental to competition or the effective functioning of the internal market or the efficient functioning of the regulated system to which the infrastructure is connected.

- (60) This criterion addresses the effects on competition as in Article 22, paragraph 1(a) of the Gas Directive and in Article 7, paragraph 1(e) of the Electricity Regulation (see chapter 2.3). However, the criterion has a different approach because its focus is not on the competitive effect of the investment, but on the possible negative effects of the exemption itself. This requires that repercussions that the exemption may have on other projects, whether regulated, exempted or submitted for exemption, need to be considered.
- (61) The effective functioning of the market may be an issue of concern where an exemption hinders the overall optimisation of the energy network. In the case of an exempted interconnector, for example, the operators have an incentive to optimise the use only of their own infrastructure, regardless of implications for congestion or production costs in other parts of the network. This situation may be prevented by imposing conditions on the project relating to the transparency and capacity management of the exempted infrastructure.
- (62) The effect on the regulated system addresses a similar issue. The construction of a new major infrastructure may require the expansion or reinforcement of the existing regulated infrastructure due to substantially increased energy flows. It is therefore necessary to consider how the exemption influences the costs of operating the regulated system if, for example, the users of the regulated system are faced with substantially increased higher network tariffs. Under this criterion, an exemption may also be motivated positively by the desire to protect the regulated system and thus customers against having to underwrite the costs of a project where both the ratio of benefits to costs is uncertain and where the costs are particularly high.
- (63) To assess this criterion, national authorities need to analyse the effect of an exemption on the existing and future (if possible) regulated infrastructure, taking into account also the impact of other projects on that regulated system, and, in the case of gas, the effect on possible barriers to free movement.

Box 7: Risk of sub-optimal capacity investment

Where a new major piece of infrastructure is likely to hold a monopolistic position and is based on a business model taking advantage of price differences between two markets, the project promoters have an incentive to construct an infrastructure with sub-optimal capacity. This strategy would allow them to maximise profits by keeping capacity scarce and auction revenues high. From the point of view of the internal market, such a situation should be prevented because it undermines market integration and security of supply. There should be a fair balance between an acceptable rate of return for the project promoters and benefits to consumers.

In the case of the BritNed electricity interconnector linking the Netherlands and the United Kingdom, the Commission identified a risk that the planned capacity would be sub-optimal. It therefore decided to include a condition in the exemption decision triggering a regulatory review after 10 years to determine whether the economics of the project would be profoundly different from the initial estimate. If the rate of return turns out to be significantly higher than estimated, BritNed should have the choice either to increase the interconnector capacity to meet the initially estimated rate of return or to accept a profit cap.

3. DECISION MONITORING

- (64) The national authorities should monitor the exemption decision in order to verify whether the assumptions underlying the exemption decision prove to be correct and to monitor compliance with the conditions which may have been imposed on the project.

4. AMENDMENT OR WITHDRAWAL

- (65) Where Member States amend exemption decisions, the Commission must be notified in accordance with Article 22(4) of the Gas Directive and Article 7.5 of the Electricity Regulation. Any decision which amends or withdraws an exemption decision, *inter alia* because of a failure by the project promoter to respect conditions laid down in the exemption decision, must be in accordance with general principles of Community law including the principles of legitimate expectations and proportionality.