

1 September 2017

Dear Stakeholder,

CLARIFICATION NOTE TO ACCOMPANY THE CONSULTATION ON IUK'S IMPLICIT ALLOCATION MECHANISM ("IAM") AND TARIFF NETWORK CODE DEROGATION APPLICATION ("TARDA").

IUK is pursuing the implementation of an Implicit Allocation Mechanism ("IAM") to create more opportunities for the market to purchase IUK capacity, in addition to the standard Capacity Allocation Mechanism Network Code ("CAM NC") auctions on PRISMA. IUK is also in the process of applying to its NRAs for a derogation to certain parts of the Tariff Network Code. Both these issues are the subject of stakeholder consultation documents published by IUK on 8 August 2017.

Following on from discussions with stakeholders, IUK is issuing this clarification note to address some questions raised by stakeholders.

1. Implicit Allocation

It has been questioned whether IUK will continue to offer capacity through CAM NC auctions on PRISMA and the impact of dis-applying Articles 8-37 of CAM NC. We would like to make the following clarification points:

- IUK will continue to offer its capacity through the CAM NC auctions via PRISMA.
- In addition, IUK is currently consulting the market on the introduction of an Implicit Allocation Mechanism. If this mechanism is introduced, IUK will continue to offer unsold capacity through the CAM NC auctions on the PRISMA platform.
- Article 2.5 of the CAM NC states that "Where implicit capacity allocation methods are applied, national regulatory authorities may decide not to apply Articles 8 to 37".
- IUK will only seek to dis-apply Articles 8 - 37 for the capacity while it is offered through the Implicit Allocation Mechanism. Disapplication of these CAM NWC Articles for the capacity offered via implicit allocation is necessary in order to allow for the implicit allocation mechanism to be introduced.
- At the time of a CAM NC auction on PRISMA all unsold capacity will be offered to the market and subject to the requirements outlined in Articles 8 – 37 of the CAM NC, even if this capacity was initially offered through Implicit Allocation.
- CAM NC requires 10-20% of capacity to be retained for short-term auctions. IUK will not offer this capacity via Implicit Allocation to ensure that it remains available for CAM NC auctions on PRISMA.
- All other capacity may be offered via Implicit Allocation when it is not being offered in the CAM NC auctions. This is subject to the limitations proposed in section 2.2.2 of the consultation letter.

2. How IUK will use its flexibility following derogation from certain Tariff Network Code articles

IUK understands that it needs to develop an operational or business model that works both for IUK and for shippers, recognising that shippers have alternative options. Of all TSOs, IUK faces the strongest possible market incentives to attract shipper capacity bookings, because it has no captive consumers and no revenues underwritten by regulation or by captive consumer demand. Its

economic viability depends on devising tariffs, products and other business model attributes that meet shippers' interests, in a way that generates sufficient revenue to cover IUK's costs and provide a return to shareholders. In this respect, IUK is in the same position as any other merchant entity: to survive and prosper in a competitive market, it has to work with its potential customers to develop an "offer" that is attractive to them. This is a question of commercial optimisation, that sits within boundary conditions determined by regulation and by compliance requirements. The optimal model will involve finding the common ground between shippers' interests and IUK's interests. The common ground will necessarily be strongly related to the standard TSO model, but it cannot be identical to it because this would not provide IUK, as an interconnector wholly exposed to the market and to competition, with the ability to achieve economic viability from October 2018, risking partial or complete closure of the business.

The objectives of the commercial business model will be to:

- provide shippers with sufficient ex ante certainty that they can evaluate options and commit to IUK capacity where it is in their interests to do so;
- provide IUK with sufficient flexibility to adjust to changing market conditions, and avoid being locked into inappropriate tariff levels or structures without the guarantee of an alternative revenue stream;
- provide for a reasonable sharing of risk; and
- remain adaptable in the face of changing market characteristics.

Process: to derive this optimal business model, IUK will follow the following steps:

1. scope out a series of key questions that need to be addressed;
2. have one-to-one discussions with interested shippers starting in September (focussing on their individual needs which will vary with their own business model and how they individually could utilise IUK capacity);
3. organise a shipper workshop to feedback findings; and
4. feed these results into the NRAs, ahead of their final decisions on IUK's regulatory submissions.

The business model will necessarily have to be within the limits of what is allowed by NRAs. It is foreseen that the NRAs' decisions will set the boundary conditions; and then it will be a commercial matter for IUK to decide how best to operate, within these limitations to create value for shippers and therefore IUK.

If you require any further information in relation to this letter or have questions regarding the proposal, please contact a member of the IUK team to discuss.