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All Stakeholders

8th August 2017

Dear Stakeholder,

Consultation on Interconnector (UK) Limited's request under Article 37 of Commission Regulation (EU) 2017/460 establishing a network code on harmonised transmission tariff structures for gas for a derogation from the application of one or more Articles of this Commission Regulation

Interconnector (UK) Limited (IUK) would like to hear stakeholders' views on its proposed derogation application from the application of one or more Articles of Commission Regulation (EU) 2017/460 (the Tariff Network Code, or hereafter the TAR Code). References in this letter to Articles, are to Articles of the TAR Code.

The proposed derogation request is outlined set out in Annex A.

1. Background

IUK is a physically bi-directional merchant gas interconnector between the GB and Belgium. Its access arrangements and its Charging Methodology (CM) are governed by the Belgian Gas Act and the GB Gas Act via a GB interconnector licence. Under these frameworks, IUK's CM is consulted on and approved by both the Belgian and GB national regulatory authorities (NRAs), CREG and Ofgem.

The TAR Code entered into force in April 2017. The TAR Code sets out rules on transmission tariffs including the application of a reference price methodology and the associated consultation and publication requirements. Article 37 allows NRAs to grant an interconnector operator derogations from the application of one or more Articles of the TAR Code if their application would have negative consequences.

Article 37 was included in the TAR Code in recognition of the fact that interconnectors are a distinct type of transmission system operator (TSO) which face different challenges to those of meshed grids. IUK meets all the characteristics noted in ENTSOG's implementation document[1] which accompanies

[1] https://www.entsog.eu/public/uploads/files/publications/Tariffs/2017/170322_ENTSOG_TAR%20NC%20IDoc_High-Res.pdf

the TAR Code including having no captive demand, competing with other flexibility assets and being a merchant asset without an allowed or target revenue.

IUK, having reviewed the obligations outlined in the TAR Code, considers that the Articles identified in this consultation require an enduring derogation. The identified provisions are either not implementable, or cause a negative impact on IUK's ability to operate as a merchant gas interconnector in a competitive flexibility market.

2. The proposed derogations

IUK is proposing derogations from the following Articles for an enduring period:

Table 1: Summary of IUK's proposed derogation from Articles of the TAR NC due to the negative consequences of implementation

Article Reference	**The negative consequences of implementation**
Paragraph 3(b)(iii) of Article 4: *Complementary revenue recovery charge*	Distorts competition and risks IUK's ability to maintain capacity as it removes from IUK the option of also using commodity charges to recover transmission revenue.
Article 5: *Cost allocation assessment*	IUK has no domestic points. The purpose and the practicality of applying the formula therefore becomes meaningless.
Paragraph 1 of Article 6: *Reference price methodology application*	Linked to Article 26 and 27. See negative consequences outlined in implementing Article 26 and 27 shown further below. Given the link to Article 26 and Article 27 a derogation is required from Article 6.1 as it requires the reference price methodology to be set in accordance with Article 27 and subject to periodic consultation as outlined in Article 26.
Paragraph (a) of Article 7: *Reproducing and accurate forecasting of reserve prices*	IUK is not able to accurately predict flows/bookings and therefore forecast tariff evolution. Even if IUK could make such predictions, it is still not appropriate from a competition point of view to consult/publish this information given that IUK competes with other flexibility assets that are not under the same obligation. The application of this Article would distort competition in the flexibility market.
Paragraph 3 of Article 12: *Reserve prices published before annual CAM auction to be binding for the subsequent gas year*	Linked to Article 29. Given no baseload demand, it is not possible for IUK to accurately predict flows/ bookings and therefore to lock in a "correct" tariff structure effectively over a year. Application of this Article would harm competition and cross border trade. IUK would not be able to respond to changing market conditions, unlike competing flexibility assets.
Article 13: *Level of multipliers and seasonal factors*	This threatens IUK's ability to maintain cross border capacity and harm cross-border trade. The relevant caps are not sufficient to enable IUK to

	achieve reasonable revenue recovery in a market that is moving strongly to short term capacity bookings.
Paragraph 4 of Article 16: *Ex-post calculation of an interruptible reserve prices*	An ex-post compensation payment option of three times the reserve price for daily products is not appropriate given IUK's risk exposure as a commercial asset with full market exposure, in a market environment which favours short term capacity bookings.
Article 26: *Periodic consultation*	The application of this Article would harm competition in the flexibility market as it would reveal commercially sensitive information to IUK's competitors (e.g. via consulting on prices and outlining other charges). Furthermore, a two-month consultation would unreasonably delay approval processes for IUK noting that other flexibility assets have no such 2 month obligation.
Article 27: *NRA decision making*	This Article is linked to the Agency (ACER) analysing the Article 26 consultation. As IUK is seeking a derogation from Article 26, for the negative consequences outlined above, an ACER review is not necessary. Furthermore, two months for an ACER assessment and five months for NRAs to make a decision would unreasonably delay IUK's ability to adjust tariffs. This harms IUK's ability to compete with other flexibility assets and respond to changing market conditions.
Article 28: *Consultation on discounts, multipliers and seasonal factors*	As a merchant asset, IUK's tariffs should not be set by NRAs. Other competing flexibility assets have no such restriction. It is not appropriate for IUK's proposed pricing structure to be consulted on and to be locked in for an extended period. Revealing commercially sensitive information to competitors would be detrimental to IUK and competition in the flexibility market, distorting competition, risking IUK's ability to maintain capacity, and distorting cross-border trade.
Paragraph (a) and paragraph (b)(i) of Article 29: *Information to be published before the annual yearly capacity auction*	Linked to Article 12.3. Given no baseload demand, it is not possible for IUK to accurately predict flows and therefore lock in a "correct" tariff structure effectively over a year. This Article would harm competition and cross border trade as IUK would not be able to respond to changing market and competitive conditions.
Sub-paragraphs (a)(ii) and (b)(iii)(2) of paragraph 1 and paragraph 2 of Article 30: *Information to be published before tariffs period specifically forecasted capacity,*	Interconnectors are single line transmission pipelines which facilitate market flexibility and arbitrage. Flows and capacity bookings will depend on market circumstances and will be highly difficult to predict. This makes forecasting capacity bookings and publishing information to enable users to forecast tariff evolution impractical. From a competition point of view, any assumptions that IUK makes in these areas are commerically sensitive. Therefore publishing such information would harm competition by allowing competing assets (who are not under the same obligation) to take advantage of this sensitive information.

cost of capital, tariff evolution	
Paragraph 2(a) of Article 31: *Form of publication*	This Article is linked to Article 29 and 30. IUK is seeking a derogation from certain parts of Article 29 and 30 due to the negative consequences noted above. Therefore this Article should be applicable only to the extent that the requirements set out in Article 29 and 30 apply.
Paragraph (a),(c) and the last paragraph of Article 32: *Publication notice period*	This Article is linked to Article 12(3), 29 and 30. IUK is seeking a derogation from Article 12(3) and certain parts of Article 29 and 30 due to the negative consequences noted above. Therefore this Article should be applicable only to the extent that the requirements set out in Article 12(3), 29 and 30 apply.

3. Why IUK needs derogations from the identified TAR Code Articles

IUK is a merchant interconnector which competes with other supply flexibility assets such as Storage, LNG and Production swing. IUK does not have a regulated allowed revenue nor the ability to recover revenue from captive demand. It relies exclusively on market demand for its revenues. This makes it very different to most other TSOs across Europe, for whom the rules in the TAR Code are largely designed. IUK needs to be able to calculate, adjust and set tariffs more flexibly than is the case for other regulated TSOs who benefit from captive demand and predictable demand patterns, and whose revenues are not dependent on market and competitive forces to a similar degree.

IUK faces a challenging environment from October 2018 when its original long term contracts come to an end. Historically, IUK has seen intermediate to low average annual utilisation with occasional periods of high utilisation. This type of utilisation pattern is expected to continue after October 2018 (even after considering the impact of the closure of GB's seasonal gas storage facility, Rough), although it remains to be seen exactly how shippers will book and utilise the asset when relying on more short term capacity contracting patterns. Despite IUK's security of supply and market integration value, the markets that IUK connects have already achieved close price convergence, in large part due to the availability of IUK's capacity. Price spreads do not reflect the wider economic benefits that IUK provides. In a market moving more and more short term, tariff flexibility is therefore vital to enable IUK to have a viable business model and to maintain cross border capacity for the benefit of market efficiency and consumers. IUK also needs a less restrictive framework when it comes to publication and transparency obligations to avoid having to share commercially sensitive information with competing flexibility assets who do not face the same obligations. Without the proposed derogations IUK will not be on a level playing field with other flexibility assets. This would harm competition in the flexibility market to the detriment of flexibility customers. The proposed derogations from the TAR Code are therefore necessary to ensure effective competition in the flexibility market.

Given these concerns, the major restrictions within the TAR Code that IUK is seeking to address via its derogation application concern 3 broad areas:

a) Determining tariffs through the application of a formula based charging methodology

The standard approach to TSO charging does not work when applied to IUK. IUK's flows and capacity bookings are highly unpredictable ex-ante. This reflects IUK's use as an arbitrage and security of supply asset with no captive demand, and its exposure to competitive forces. Therefore, it is difficult to determine a set of tariffs which would recover IUK's costs with a reasonable level of reliability. This also makes obligations such as consulting on information outlined in Article 7 (reproducing and accurate forecasting of reserve prices) difficult and misleading given that it would be inaccurate.

b) Restrictions on adjusting tariffs and caps on these tariffs

Linked to above, Article 12.3 and Article 29 would lock in a tariff structure before the annual CAM auction. To do this requires a reasonable ability to forecast future bookings accurately. IUK is not in this position, as demand for capacity is highly contingent on market and competitive conditions. IUK also needs the ability to respond to changing market conditions by adjusting tariffs. This flexibility is appropriate to ensure that competition in the flexibility market is not harmed and IUK can compete fairly with other flexibility assets who have no such restrictions.

Furthermore, as IUK bears full market exposure and will rely on short term capacity bookings from October 2018, it needs the ability to set short term tariffs without any of the multiplier caps set out in Article 13. This will reduce the risk of IUK becoming financially unviable and give it the best chance to continue to maintain its capacity, to the benefit of the market and consumers.

c) Consultations and publications which reveal commercially sensitive information

Articles 26-28 set out obligations to consult on a number of parameters (e.g. multipliers). Article 29-30 set out obligations to publish a number of parameters (forecasted capacity and tariffs). Some of the obligations would reveal IUK's pricing strategy and other commercially sensitive information to competitors who would also be aware that IUK would be locked into this pricing strategy for a significant period of time. As a merchant interconnector in a competitive market it is not appropriate for IUK's prices to be consulted on months in advance of the actual auction. This is unfair compared to other flexibility assets under no such requirement and would harm effective competition in the flexibility market.

4. <u>How IUK will ensure its charging remains objective, transparent and non-discriminatory</u>

IUK is seeking derogations from the identified Articles to ensure an appropriate degree of tariff flexibility. However it should be noted there are a number of safeguards and checks to ensure IUK's prices are fair and transparent:

- IUK's obligations under the Belgian Gas Act and GB interconnector licence obligations continue to require IUK to consult stakeholders for at least one month and obtain NRA approval for changes to its Charging Methodology (CM);
- IUK is obliged to review the CM annually to ensure that it remains compliant with the relevant charging methodology objectives under its interconnector licence;
- IUK must continue to publish a charging statement with applicable prices and charges;
- IUK will be implementing the other applicable provisions of the TAR Code including publishing relevant information on the ENTSOG transparency platform;
- IUK is committed to providing NRAs, confidentially, the parameters/ assumptions used to derive its proposed annual reference price, before its publication;

- IUK is committed to publishing prices sufficiently in advance of offering the capacity to meet the needs of shippers/ potential capacity purchasers[2];

- IUK will continue to provide capacity and price information for the standard CAM auctions as required by the PRISMA rules to comply with the CAM network code;

- IUK is committed to publishing indicative price information on its standard CAM products for the coming gas year no later than thirty days before the annual yearly capacity auction; and

- Additionally, the Belgian NRA, CREG is proposing to establish a financial control regime on IUK which is designed to provide a safeguard against excess profit[3].

5. Your feedback

IUK is interested in hearing your views on its proposed derogation application from one or more Articles of the TAR Code.

IUK would appreciate comments from all interested parties. IUK would welcome your response to these specific questions:

- Do you agree that the derogations from the TAR code proposed are appropriate for IUK as a gas interconnector with full market exposure?

- Do you have any other feedback on the proposed application?

Please send your response to consultation@interconnector.com by 17:30 UKT on 7th September 2017.

Please ensure that a "read receipt" is requested to confirm that your response has been received. Please note that any responses not marked confidential may be published on IUK's website. Confidential responses may be shared with Ofgem and CREG at their request.

Additionally, if any party would like a more detailed explanation of IUK's prevailing regulatory framework, and how the proposal is consistent with that framework, IUK would be happy to arrange a bilateral meeting to discuss this.

If you wish to clarify any aspect in relation to this letter, or have any questions, please contact Pavanjit Dhesi on +44 (0)78 666 832 or Pavanjit.dhesi@interconnector.com

Yours faithfully

PDHESI

PAVANJIT DHESI
Senior Regulatory Economist

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[2] Such a commitment has been included in proposed changes to IUK's Charging Methodology. These proposed changes are also being consulted on in the period 8th August until 7th September 2017. For further details please see: http://www.interconnector.com/about-us/our-consultations/latest-consultation/
[3] The CREG consultation is open from the 8th August until the 5th of September 2017. For further details please see http://www.creg.be/fr/consultations