

POLICY *brief*

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EU Electricity Interconnector Policy: Shedding Some Light on the European Commission's Approach to Exemptions

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Highlights

- In order to foster infrastructure investment, National Regulatory Authorities (NRAs) may exempt privately funded electricity interconnectors from one or more of the following: (i) regulated third party access (TPA), (ii) restrictions on the use of congestion revenues, (iii) tariff regulation and (iv) ownership unbundling.
- National exemption decisions are reviewed by the European Commission (EC) when interconnectors touch two or more Member States. So far, four so-called "merchant" projects have reached the EC (all were approved): EstLink (2005), BritNed (2007), Imera/East-West Cables (2008) and Arnoldstein-Tarvisio (2010).
- Without explanation, the EC has been gradually tightening the reins on the exemption regime since first approving an exemption in 2005. Yet analysis of these cases reveals an implicit set of preferences narrowly tailored to enable the development of a high-risk project without unduly advantaging its sponsor.
- By analysing the existing EU exemption cases, this policy brief aims to uncover the EC's implicit preferences with regards to exemptions from the regulatory provisions governing cross-border interconnector development and operation.



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Background

The Electricity Directive generally promotes electricity interconnector investment on a fully regulated basis by a transmission system operator (TSO) in order to “ensur[e] the long term ability of the system to meet reasonable demands for the transmission of electricity.”¹ As an exception, exemptions from the regulatory framework are available in cases where an interconnector’s risk level is “such that the investment would not take place unless the exemption is granted.”² The primary risks affecting interconnector investments are non-use and future change in costs and/or revenues, e.g. revenues would be negatively affected by volume or price fluctuations or future changes to congestion management rules.³ Exemptions give project owners greater control over cash flow, which increases business opportunity when determining an investment’s payback period. A full exemption provides maximum control, by making inapplicable regulated TPA, restrictions on the use of congestion revenues, regulation of tariffs and since 3 March 2011 ownership unbundling; however, such independence from the regulatory framework may be detrimental to competition. For example, where an exemption from regulated TPA enables a dominant undertaking in one of the linked markets “to consolidate its position or otherwise foreclose the market.”⁴ Thus, partial exemptions (i.e. exemptions covering only a portion of total capacity or, for example, applying to third party access but not tariff regulation) may be granted to projects whose business risk level does not justify the potential risk to competition of a full exemption.⁵

Eligibility for an exemption

The existing EU regulatory framework promotes electricity interconnector investment within a regulated access regime as part of a Member State’s regulated asset base (“RAB”). Exemptions are intended to enable investment only in those projects deemed too risky to be developed as part of the RAB. To determine eligibility for an exemption, a project must pass a six-part risk and competition analysis outlined

in Article 17(1) of the Electricity Regulation (the “Threshold Test”). This determination is made by each NRA on a case-by-case basis and, ultimately, approved or rejected by the EC in cases where interconnectors involve more than one Member State. A successful applicant is eligible for an exemption from one or more of the following (i) regulated TPA, (ii) restrictions on the use of congestion revenues, (iii) tariff regulation and (iv) ownership unbundling.

Box 1 - The current exemption request procedure

1. *Submit Request.* Applicant submits a “request for exemption” to the NRAs
2. *National Decision(s).* Since the establishment of ACER, the NRAs must inform ACER of their decision within six months. If the NRAs do not reach a decision, ACER may decide on their behalf
3. *EC Review.* Within two months after being notified (?) of a national-decision, the EC will either approve the exemption or request that the NRAs modify or withdraw their decision⁶

What is the Role of the EC in the Exemption Decision Process?

Exemptions granted by NRAs are subject to EC review where projects involve two or more Member States. Such practice shall “ensure a consistent application of the exemption practice and safeguard the wider European interest.”⁷ The EC may approve, reject or modify a national exemption decision in the final stages of the exemption request process, making the process itself a significant risk for investors. These late stage conditions are not yet predictable, and, thus, represent a risk for merchant projects that typically incur several years of planning costs before submitting an exemption request. Aggravating this situation, the EC’s actual criteria in making a decision are not yet fully revealed, appearing only implicitly in the exemption decisions.

1. Article 12(a) of the Electricity Directive and section 1.1 of Commission Staff Working Paper SEC(2009)642.

2. Article 7(1)(b) of the Electricity Regulation.

3. Section 1.3(10) of Commission Staff Working Paper SEC(2009)642.

4. See section 35 of the Exemption decision on the East-West-Cable Project, dated 19 December 2008 (the “Imera Exemption Decision”).

5. “Exemptions must be limited to what is strictly necessary to realize the investment and the scope of the exemption has to be proportionate.” Section 1.3(17) of Commission Staff Working Paper SEC(2009)642.

6. This initial two-month period is subject to extension where the EC requests additional information or by consent of the relevant parties

7. Note 4, at section 12.

The Cases So Far

EstLink (2005). Estlink is a submarine 350 MW HVDC twin-cable interconnector constructed to link the electricity transmission grids of Estonia and Finland. On 27 April 2005, the EC confirmed the national level exemption from regulated third party access, restrictions on the use of congestion revenues and tariff regulation until 31 December 2013. On or before that date, Estlink will be transferred to Fingrid Oy and the TSOs in the Baltic States. The EC did not request any modification to the NRA decision.

BritNed (2007). BritNed is a submarine 1000 MW HVDC cable constructed to link the electricity transmission grids of Great Britain and the Netherlands. On 18 October 2007, the EC approved a twenty-five year exemption. However, due to its concern that BritNed may have undersized the capacity of the interconnector in order to artificially inflate congestion revenues, the EC requested that the NRAs amend their exemption decisions with the addition of a financial review after ten years of operation. At such time, BritNed must present the NRAs with a report of total costs, total revenues and the rate of return using 2007 as a base year.⁸ If the actual ex post revenue estimate is more than one percentage point greater than the estimate contained in BritNed's exemption request, BritNed will be given two options: (a) increase capacity – this additional capacity will not be covered automatically by the original exemption; or (b) cap any profits (discounted to 2007 levels) that exceed BritNed's estimated rate of return by more than one percentage point and surrender such excess to be used to finance the RAB in the UK and the Netherlands.⁹

Imera/East-West Cables (2008). Imera is a submarine 700 MW HVDC dual-cable interconnector that was anticipated to link the grids of Ireland and Great Britain. On 19 December 2008, the EC approved a twenty-five year exemption from regulated third party access, restrictions on the use of congestion revenues and tariff regulation. In its analysis, the EC concluded that Imera satisfied the risk threshold only because of the “significantly higher economic risk” created by the planned development of a competing, fully regulated interconnector (EirGrid).¹⁰ The completion of EirGrid and the actual availability of its capacity were the principal conditions to approval.¹¹ Other conditions included: a 40% ca-

capacity cap for any dominant undertaking in either system or market to which the interconnector is connected; effective congestion management pursuant to the Congestion Management Guidelines, including intra-day trading; and, assessment by CER and Ofgem of the effectiveness of Imera's facilitated secondary trading and UIOLI procedures.¹²

Arnoldstein-Tarvisio (2010). Arnoldstein-Tarvisio is an overland Austria to Italy AC interconnector with a nominal voltage of 132kV and a maximum capacity of 160 MVA. On 26 October 2010, the EC issued a decision approving the exemption but requesting that the 50% exemption from regulated TPA granted by the NRAs should be withdrawn altogether so that 100% of capacity is available for auction. Rejecting the applicant's argument that reserving capacity was necessary to recover its investment, the EC reasoned that since the congestion management guidelines require unused capacity to be sold on the secondary market, reserving capacity was not necessary to recovering the investment. Auctioning 100% of capacity should be equally as effective.¹³ In addition, any further exemption for significant capacity increases must be approved by the EC; and, the exemption will expire if the interconnector is not operational within five years.¹⁴

Shedding Some Light on the EC's Reasoning

The analysis of the existing cases reveals an implicit set of preferences on the EC's side as an exemption can touch one or more of TPA, congestion revenues, tariffs and unbundling to differing degrees (from full exemption to very partial or very temporary exemption). To shed some light on the EC's reasoning, we use a three-point approach consisting of the three conditions raised most often in the EC's decisions (see *Box 2*).

Out of four cases, only one (EstLink) was approved without the imposition of additional conditions. As *Box 2(c)* shows, the EC imposed conditions on the other three merchant interconnectors based solely on the third point of analysis: “whether exempting a project from certain aspects of regulation would harm competition.” In other words, it was the sanctioned departure from the regulatory framework, not the proposed interconnector itself that the EC deemed problematic. A “Maybe” led, in all cases, to the imposition

8. Section 13(a) of the BritNed Exemption Decision by the European Commission, dated 18 October 2007.

9. *Supra* at subsections 13(b)(i) and (b)(ii).

10. Section 25 of the Imera Exemption Decision.

11. *Id.* at sections 27 and 55.

12. *Id.* at section 56.

13. Sections 22-27 of the Arnoldstein-Tarvisio Exemption Decision, dated 26/10/2010.

14. *Id.* at sections 35-41.

Box 2**(a) Three Conditions for an Approval of an Exemption**

<i>The interconnector must enhance competition</i>	A general competition analysis is conducted – the interconnector must show a positive effect on competition.
<i>The risk level must necessitate an exemption</i>	The risks must rise to a level that rules out development of the interconnector as a regulated investment.
<i>Granting an exemption must leave competition unharmed</i>	Focus is on whether exempting the project from regulation would harm competition conditions.

(b) The EC's Analysis of the Four Cases

	<i>EstLink</i>	<i>BritNed</i>	<i>Imera</i>	<i>Arnoldstein -Tarvisio</i>
<i>Would the interconnector enhance competition?</i>	YES	YES	YES	YES
<i>Does risk level necessitate an exemption?</i>	YES	YES	YES	YES
<i>Would exemption leave competition unharmed?</i>	YES	MAYBE	MAYBE	MAYBE

(c) Consequences of a "Maybe" by the EC

<i>Additional Conditions Imposed →</i>	<i>Review of Revenues (de facto cap)</i>	<i>Cap on Capacity share held by any single party</i>	<i>Congestion Management Requirements</i>	<i>Withdraw Exemption</i>
<i>BritNed</i>	X			
<i>Imera</i>		X	X	
<i>Arnoldstein-Tarvisio</i>				X

of additional conditions intended to ensure conformity with the exemption criteria, e.g. the review of revenues imposed on BritNed was intended to counterbalance the risk that BritNed intentionally undersized capacity in order to boost revenues from artificially created congestion.¹⁵

Conclusion

Since approving the first exemption in 2005, the EC has been gradually tightening the reins on the exemption regime: the EstLink exemption was approved by the EC without condition, while the latest decision, Arnoldstein-Tarvisio, re-

quested the complete withdrawal of a national level TPA exemption. In the absence of explicit evidence, it is not clear whether the EC's increased stringency represents an intentional shift in attitude towards the exemption regime (and/or divergence in the EC's standards and those of national regulators). It is clear, however, that the spectre of additional conditions in the final stage of the exemption approval process has a *de facto* chilling effect on merchant investment. At a time when additional interconnection capacity is crucial to the achievement of the single energy market in 2014, the EC might consider loosening its grip?

15. Note 4, at Box 7.