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COMMISSION OPINION

of 26.3.2013

**pursuant to Article 3(1) of Regulation (EC) No 715/2009 and Article 10(6) of
Directive 2009/73/EC – United Kingdom –Interconnector UK Limited**

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I. PROCEDURE

On 30 January 2013 the Commission received a notification from the national regulatory authority in the United Kingdom responsible for Great Britain, the Authority for Gas and Electricity Markets, (hereafter, "Ofgem"), in accordance with Article 10(6) of Directive 2009/73/EC¹ (hereafter, "Gas Directive"), of a draft decision on the certification of Interconnector (UK) Limited (hereafter "IUK").

Pursuant to Article 3(1) Regulation (EC) No 715/2009² (hereafter, "Gas Regulation") the Commission is required to examine the notified draft decision and deliver an opinion to the relevant national regulatory authority as to its compatibility with Article 10(2) and Article 9 of Directive 2009/73/EC.

II. DESCRIPTION OF THE NOTIFIED DECISION

IUK owns and operates a sub-sea gas pipeline and terminal facilities which provide a bi-directional link between the United Kingdom ("UK") and Continental European energy markets. IUK was established in 1994 as a joint venture between 9 energy companies which took equal shareholding in the company and capacity in the interconnector under a Shareholder's agreement and standard transportation agreements (STAs).

IUK notified these arrangements on 9 March 1995 and received an administrative letter from the Commission's Directorate General for Competition on 17 May 1995 indicating that sufficient justification had been provided for an exemption from the application of then Article 85(1) of the EC (now Article 101(1) TFEU) Treaty in respect of restrictions to competition³. This was explicitly stated to be subject to reconsideration if the factual or legal situation changed as regards an essential aspect of the arrangements.

The infrastructure was completed in 1998 and went into operation in October of that year with a total capacity of 20bcm per annum forward flow (from Belgium to the UK) and 8.5 bcm reverse flow (from UK to Belgium). Reverse flow was expanded in November 2005, October 2006 and October 2007 and now amounts to 25.5 bcm.

Since IUK became operational the beneficiaries of the STAs have changed. Likewise the shareholdings have changed and 7 persons now hold shares in IUK, namely Gasbridge 1 BV (15.75%), Gasbridge 2 BV (15.75%), OAO Gazprom (10%), Conoco Phillips (10%), Caisse de Depot et placement du Québec (23.5%), CDP Investissements (10%) and Fluxys Europe

¹ Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, OJ L 211/94 of 14.8.2009.

² Regulation (EC) No 715/2009 of the European Parliament and of the Council of 13 July 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No 1775/2005, OJ L 211/136 of 14.8.2009.

³ Case no. IV/C-2/35.363

BV (15%). Of these OAO Gazprom and Conoco Philips or their subsidiaries or parent companies have interests in the production or supply of natural gas.

According to the documentation submitted by IUK in its application, none of its shareholders exercises control over IUK. However, all shareholders, including shareholders with interests in the production or sale of natural gas currently exercise rights in IUK. IUK has undertaken to implement changes to its corporate governance arrangements such that from 3 March 2015 shareholders with interests in the production or supply of natural gas will no longer be able to exercise rights.

Ofgem has analysed whether and to what extent the Applicant complies with the requirements of the UK legislation transposing the Gas Directive. This legislation provides for the possibility of certification of a transmission system operator which benefits from an exemption under Article 22 of Directive 2003/55/EC (which was repealed and replaced as of 3rd March 2011 by the current Gas Directive 2009/73/EC)⁴ or which is in a "substantially similar" position to the beneficiary of such an exemption. In its draft decision, Ofgem has found that IUK can be considered to be in a "substantially similar" position to the beneficiary of such an exemption until 3 March 2015, when it will have to change its corporate governance arrangements, and subsequent to that date will have to comply with the requirements of full ownership unbundling. On this basis, Ofgem submitted its draft decision to the Commission requesting an opinion.

III. COMMENTS

On the basis of the present notifications the Commission has the following comments on the draft decision.

EXERCISE OF CONTROL AND RIGHTS IN THE APPLICANT

Article 9(1)(b)(i) Gas Directive prohibits the same person(s) from directly or indirectly exercising control over an undertaking performing any of the functions of generation or supply, and directly or indirectly exercising control or exercising any right over a transmission system operator (TSO) or over a transmission system.

Article 9(1)(b)(ii) Gas Directive prohibits the same person(s) from directly or indirectly exercising control over a TSO or over a transmission system, and directly or indirectly exercising control or exercising any right over an undertaking performing any of the functions of generation or supply.

Article 9(1)(c) and Article 9(1)(d) Gas Directive require that members of the management of the TSO and persons that have the right to appoint them, must fulfil certain requirements of independence. In particular, the same person or persons are not entitled to directly or indirectly exercise control or exercise any right over an undertaking performing any of the functions of production or supply and at the same time be or appoint members of the supervisory board, the administrative board or bodies legally representing the undertaking (Article 9(1)(c)), and the same person is not entitled to be a member of the supervisory board, the administrative board or bodies legally representing both an undertaking performing any of the functions of production or supply and a transmission system operator or a transmission system (Article 9(1)(d)).

OFGEM'S ASSESSMENT

⁴ Article 22 of Directive 2003/55/EC in particular, has been replaced by Article 36 of Directive 2009/73/EC.

Ofgem assesses whether IUK would have been granted an exemption under Article 22 of Directive 2003/55/EC had it been possible to make such an application prior to the construction of the new infrastructure. They note that the initial investors sought regulatory certainty regarding their investment by means of the comfort letter from the Commission in relation to the compatibility of the agreement on the marketing of the new capacity with competition rules. However, Ofgem explicitly states that this is not equivalent to a formal Article 22 exemption decision either in scope or legal effect.

In order to apply the "substantially similar" test provided for in UK law, Ofgem considers it necessary to establish if IUK would have been granted an exemption if the process under Article 22 had been in existence prior to the construction of the infrastructure (i.e. before 1996). On this basis Ofgem assessed in detail whether the tests set out for the granting of an exemption could be considered to have been met, in what they describe as "a difficult process of historical enquiry". Ofgem considers that it is indeed likely that they would have concluded that IUK met the tests, and thus that it is possible therefore that an Article 22 exemption would have been granted until 3 March 2015. On this basis they conclude that IUK should be certified on the "substantially similar" grounds provided for in UK law until that date.

Ofgem goes on to assess the arrangements which IUK has committed to putting in place from 3 March 2015 onwards, in accordance with a transition plan submitted as part of its certification application. This transition plan includes changing the Articles of Association and the Shareholders Agreement, to provide *inter alia* for the establishment of a nominations committee who will appoint independent directors replacing the directors currently appointed by the conflicted shareholders, removing voting rights from the conflicted shareholders and preventing the sharing of information between IUK and its shareholders.

COMMISSION VIEW

The Commission must undertake the assessment as to whether IUK complies with the unbundling requirements as set out in Article 9 of the Gas Directive directly and not by reference to the national transposing legislation.

Status of IUK and Article 22 exemption

Exemptions grant rights to the parties taking the risk to invest in the infrastructure by freeing them from obligations that otherwise would have been applicable to them; exemptions also need to strike the right balance between the promotion of necessary investments on the one hand and the objective of ensuring competition through fair and non-discriminatory access on the other. The Commission has addressed the status of transmission systems benefitting from an Article 22 exemption in a previous opinion⁵. In particular this opinion notes that Recital (35) of the Gas Directive states "... given the exceptional risk profile of constructing those exempt major infrastructure projects, it should be possible temporarily to grant partial derogations to undertakings with supply and production interests in respect of the unbundling rules for the projects concerned (...) Exemptions granted under Directive 2003/55/EC continue to apply until the scheduled expiry date as decided in the granted exemption decision."

However, the above recital is not relevant in the current case as it is a matter of fact that IUK does not benefit from an Article 22 exemption. This means that the necessary analysis to balance the objectives of ensuring fair and non-discriminatory access against the benefits of

⁵ Commission's Opinion on e-Control's draft certification decision for NABUCCO C(2012)9575

promoting new and necessary investments which the granting of an Article 22 exemption requires was not undertaken in relation to IUK. It is noted that the full ownership unbundling requirements set out in Article 9 of Directive 2009/73/EC do not envisage possibility for derogation from their application depending on whether the applicant for certification, even if not a beneficiary of an Article 22 exemption as such, is in a position "substantially similar" to the beneficiary of such an exemption.

Furthermore, there is no provision in either Directive 2003/55/EC and 2009/73/EC for the granting of *ex post* exemptions from either unbundling or third party access rules, in fact the possibility of exemption is expressly confined to "new infrastructure". Therefore the Commission does not consider it necessary to engage in the counterfactual analysis necessary to establish what decision would have been taken had different rules been in place in 1995/1996 and had there also been a procedure in place to grant exemptions from the application of those rules. The Commission considers that such an approach would necessitate an unjustifiable level of conjecture on the part of the Commission, most notably as to the duration of any exemption⁶.

Finally, and for the avoidance of doubt, the Commission agrees with Ofgem that the comfort letter of 1995 cannot be considered equivalent to an Article 22 exemption decision.

Full ownership unbundling

As IUK was not a vertically integrated undertaking on 3 September 2009 it is required to comply with the requirements of full ownership unbundling as set out in Article 9(1) *et seq.* of the Gas Directive.

Based on the information provided by Ofgem and IUK, the Commission concludes that no person exercises control over IUK, thus it must be the case that no person directly or indirectly exercises control over IUK, while at the same time exercising control or rights over an undertaking performing any of the functions of production or supply. On this basis the Commission is satisfied that the requirements of Article 9(1)(b)(ii) of the Gas Directive are complied with. This means that IUK is not part of a vertically integrated undertaking

According to the information provided by IUK in the application for certification, more than one person who controls production or supply undertakings currently does exercise rights in relation to IUK, specifically rights to appoint Directors and the right to exercise voting rights. Such rights are not in compliance with Article 9(1)(b)(i) or Article 9(1)(c) of the Gas Directive and were required to be removed by 3 March 2011, with the possibility of derogation to 3 March 2013 on the basis of Article 9(4) Gas Directive. Furthermore the Commission understands from the assessment in the preliminary decision that there could be persons appointed as Directors of IUK who are simultaneously members of the supervisory board, the administrative board or bodies legally representing production or supply undertakings in contravention of Article 9(1)(d) Gas Directive. Also this should have been remedied by 3 March 2011.

IUK proposes to remedy these deficiencies by 3 March 2015 and fully meet the requirements of full ownership unbundling from that date. These proposals have been formally submitted to

⁶ This is clear from the notified decision where Ofgem, considering itself required to undertake such an analysis on the basis of UK law, merely states that it is possible that they would have granted an exemption until 3 March 2015.

Ofgem as part of the application for certification. Ofgem states that these will be reflected in the conditions to IUKs certification.

The Commission considers it appropriate to assess Ofgem's preliminary decision on the basis that the undertakings provided by IUK and the related conditions which Ofgem intends to impose are, in fact, fulfilled and separately consider the appropriateness of such a transition period.

Removal of rights of conflicted shareholders

As part of its application for certification IUK undertakes to amend its Articles of Association such that a new definition of conflicted shareholder will be introduced which comprises shareholders that directly or indirectly exercise control or any rights over undertakings that are involved in electricity generation and supply or gas production and supply, or are part of a corporate grouping that exercises such control or rights. Furthermore,

- IUK undertakes that such shareholders will be obliged to remove any Director they have appointed;
- IUK undertakes that such shareholders will lose their rights to appoint Directors or to vote on the Managing Director;
- IUK undertakes that conflicted shareholders will lose shareholder voting rights;
- IUK undertakes to restrict the information it provides to conflicted shareholders to the reporting of the decisions taken by the board and/or by the shareholders, financial reports, forecasts and accounts audit reports and significant events which could have a material impact on dividends;
- IUK undertakes to make explicit that conflicted shareholders will not be able to appoint any members to IUK committees.

Ofgem proposes to impose conditions in its decision to certify IUK which make certification condition upon compliance with these undertakings.

The Commission considers that if these undertakings and conditions are met, the requirements of Article 9(1)(b)(i) and (c) of the Gas Directive would be complied with. The Commission therefore supports making the certification conditional on fulfilling the undertakings at issue.

Removal of conflicted directors

IUK undertakes as part of its application for certification to amend its Articles of Association such that any Director who subsequently becomes a Director or senior officer of any undertaking involved in electricity generation and supply or gas production or supply will be automatically removed from their position of Director at IUK.

Ofgem proposes to impose conditions in its decision to certify IUK which make certification condition upon compliance with these undertakings.

The Commission considers that if this undertaking is met the requirements of Article 9(1)(d) of the Gas Directive would be complied with. The Commission therefore supports making the certification conditional on fulfilling the undertakings at issue.

Establishment of nominations committee and appointment of independent Directors

In order to address potential governance issues caused by the non-appointment of Directors by conflicted shareholders IUK proposes to provide for the appointment of independent directors.

For this purpose IUK proposes to establish a nominations committee whose role will be to draw-up a shortlist of potential independent directors. Independent directors will be appointed by the board. The members of the nominations committee will be existing independent directors.

IUK undertakes to provide a report to Ofgem demonstrating that each independent director complies with the nominations committee terms of reference, a draft of which is provided and which specifically stipulates *inter alia* that each independent director: has relevant industry knowledge and technical, commercial, regulatory, legal and/or financial skills which are relevant to IUK and which date back at least 10 years; is not and has not been during the previous three years employed, engaged or otherwise associated with any of the IUK Shareholders or IUK shippers, or a member of their respective corporate groups; is not and has not been during the previous three years a senior officer of any undertaking involved in electricity generation and supply or gas production and supply; and does not have an existing direct or indirect interest that conflicts, or possibly may conflict, with the interests of IUK.

Ofgem proposes to impose conditions in its decision to certify IUK which give effect to these undertakings. The Commission considers that the appointment of independent directors who meet the criteria described above and who are appointed by a wholly independent nominations committee would not be in conflict with the requirements of Article 9(1)(b), (c) or (d).

Transition period to full ownership unbundling and monitoring by Ofgem

IUK in its application recognises that its existing corporate arrangements do not currently comply with the requirements of full ownership unbundling and states that the changes outlined above are significant and require a period of transition to implement. Ofgem shares this assessment. IUK highlights the need to ensure effective governance following the removal of the rights of conflicted shareholders – for instance in regards to quorums for shareholder meetings and the effective functioning of the Board.

IUK proposes a timeline which is set out in the transition plan which would see the new arrangements implemented on 3 March 2015. During the period until this date conflicted shareholders would continue to exercise rights in IUK, including the right to appoint Directors, the right to exercise voting rights, and the right to fully participate in board and shareholder meetings.

IUK undertakes that it will report to Ofgem on a quarterly basis the steps being taken to implement full ownership unbundling.

Ofgem proposes to include in its certification decision a requirement that IUK establishes and maintains a compliance programme to review and report on a quarterly basis to Ofgem its adherence to the conditions included in the certification decision, and its adherence to the transition plan in order to ensure compliance with the undertakings discussed above.

The Commission recognises the particular situation of IUK, which has acted as important link between the British and continental European markets for years and which in many respects was at the forefront of the introduction of flexible and transparent gas transport arrangements

in the internal energy market. The Commission recognises that this infrastructure was built at a time when different and more limited unbundling rules applied and when the current system of exemptions for new infrastructure was not in place. The Commission acknowledges that, in this case, an abrupt removal of rights from conflicted shareholders in IUK could lead to difficulties in corporate governance and would not be proportionate given the uncertainty which the shareholders had as regards the applicability of unbundling rules given the comfort letter already referred to and the provisions of UK law. A transition period of two years in these specific circumstances is reasonable. Moreover, a transition period to 2015 ensures that IUK will be fully unbundled when new contracts are negotiated to apply following the expiry of the existing contracts in 2018.

However, the Commission considers that it is of the utmost importance that the provisions relating to ensuring effective unbundling be fully implemented as soon as possible. The Commission therefore invites Ofgem to assess whether compliance with the conditions for fully complying with the ownership unbundling requirements cannot be objectively achieved before 3 March 2015. Should Ofgem reach a positive conclusion, the Commission invites Ofgem to require compliance with the conditions by an earlier date.

The Commission considers it to be of critical importance in this case that the IUK fully meets the commitments made in the compliance programme and that Ofgem is able to regularly supervise the process. The Commission therefore supports Ofgem including a reporting obligation on a quarterly basis on progress made with the compliance programme as a condition in the certification, along with including the substantive conditions concerning the ownership unbundling requirements.

Provided that the compliance programme set out in the transition plan is adhered to, and that IUK continues to take without delay the steps envisaged therein, being subject to regular monitoring of progress by Ofgem, the Commission considers that IUK can be certified as a transmission system operator by a conditional certification decision.

Finally the Commission considers that the rules relating to full ownership unbundling apply equally to the subsidiary companies of IUK.

IV. CONCLUSION

Pursuant to Article 3(2) Gas Regulation, Ofgem shall take utmost account of the above comments of the Commission when taking its final decision regarding the certification of the IUK, and when it does so, shall communicate this decision to the Commission.

The Commission's position on this particular notification is without prejudice to any position it may take *vis-à-vis* national regulatory authorities on any other notified draft measures concerning certification, or *vis-à-vis* national authorities responsible for the transposition of EU legislation as regards the compatibility of any national implementing measure with EU law.

The Commission will publish this document on its website. The Commission does not consider the information contained herein to be confidential. Ofgem is invited to inform the Commission within five working days following receipt whether it considers that, in accordance with EU and national rules on business confidentiality, this document contains confidential information which it wishes to have deleted prior to such publication. Reasons should be given for any such request.

Done at Brussels, 26.3.2013

*For the Commission
Günther Oettinger
Member of the Commission*