

## Re: SOUTH NORTH PIPELINE EXIT TARIFF

---

### ADVICE: EXIT TARIFF

---

#### **Introduction**

1. I am instructed jointly by the Commission for Energy Regulation (“CER”) and the Utility Regulator (“UR”) to advise as to whether the decision of the CER of 27 July 2012 to impose a tariff for exit (“the Exit Tariff”) from the Irish gas network (“the Gaslink System”) in to the South North Pipeline (“SNP”) is compatible with EU law.<sup>1</sup>
2. For the purposes of this advice I have been provided with a short clip of documents under cover of a letter of instructions dated 19 March 2014 and have had the benefit of a telephone conference with both my clients at which various factual issues were explored. One further query was answered by email on 16 and 17 April 2014. In addition, I have now considered some comments on a first draft of this Advice from the CER.
3. For the reasons I explain below, my view is that the Court of Justice of the European Union - the ultimate arbiter of questions of EU law - would be likely to conclude that the Exit Tariff is not compatible with EU law.

#### **The facts**

4. As I understand it, the material facts are as follows.

---

<sup>1</sup> This advice is confined to issues of EU law, rather than the domestic law of either the Republic of Ireland or Northern Ireland.

### *The pipelines*

5. The Republic of Ireland is connected to Great Britain by two gas pipelines known as IC1 and IC2 (“the ICs”) with an entry point at Moffat in Scotland. IC1 was built in 1993 and has a capacity of 17 mcm/d.<sup>2</sup> IC2 was built in 2002 and has a capacity of 23 mcm/d. The total amount of gas that can be shipped at any one time through IC1 and IC2 is limited to 23 mcm/d. This is due to the technical limits of the equipment at Brighthouse Bay, near Moffat. The CER considers that the annual required revenue for both IC1 and IC2 is €50 million.
  
6. Both IC1 and IC2 are in regular use. Occasionally, peak demand in the Republic of Ireland exceeds 23 mcm/d. There is an additional gas entry point at Inch which provides a further gas supply to the Republic of Ireland, although 95% of demand within the Republic of Ireland is satisfied by gas shipped over the ICs. The practical effect is that IC1 and IC2 provide security of supply in the event that one or other pipeline fails.
  
7. Northern Ireland is connected to Great Britain by a gas pipeline known as the Scotland Northern Ireland Pipeline (“SNIP”) with an entry point at Moffat. SNIP is the sole source of gas supply in Northern Ireland (except the SNP) and is able to meet Northern Ireland’s maximum demand.
  
8. The SNP was built by BGÉ(NI), a Transmission System Operator in Northern Ireland. It connects to the Irish gas system at Gormanston in the Republic of Ireland. Specifically, SNP connects to IC2 (but not IC1). The SNP has a maximum flow of 5 mcm/d.

---

<sup>2</sup> For the purposes of this Advice I have referred to “mcm” rather than “mscm” as I understand there is no material difference for present purposes.

9. My instructions explain that the SNP “spans the regulatory jurisdictions of CER (ROI) and UR (NI) and is part of the Northern Irish Regulatory Asset Base.” The costs of both SNIP and SNP are recouped through the NI transmission tariff.
  
10. The effect is to provide Northern Ireland with a second means by which to access gas shipped from Great Britain (via IC2 and the SNP). In practice however, those sections of the SNP within Northern Ireland are used to distribute gas flowing from the SNIP, but the SNP is not used to ship gas from the Republic of Ireland to Northern Ireland. I understand that it is significantly cheaper to transport gas to Northern Ireland using SNIP rather than the ICs and SNP – irrespective of the Exit Tariff which I am asked to consider. This is essentially because the “postalised tariff” that applies in Northern Ireland already includes the cost of shipping gas over the SNIP. Thus, if gas is shipped to a Northern Ireland destination over the SNP and IC2, a user would effectively have to pay for transmission from the UK twice: once under the postalised tariff, and once under the Entry Tariff. The additional cost also reflects the additional distance gas must travel to reach Northern Ireland if it travels over IC2 and the SNP rather than the SNIP.

***The question referred to the Commission***

11. As part of a project known as Common Arrangements for Gas (“CAG”), the CER and the UR sought to agree tariff arrangements for use of the SNP. In May 2011 the following question was jointly referred to the European Commission:

“whether the relevant EU legislation (interpreted in the light of the policy purposes set out in the recitals) would allow the CER to approve a regulatory and/or contractual framework for the Irish TSO to require an ongoing security of supply payment from a Northern Ireland TSO/supplier on the same basis as is charged to Irish customers as a condition for access to IC2.

Putting the question differently, would the Irish TSO be entitled under EU law, to deny access to IC2, if and when requested by a Northern Ireland TSO/supplier, on the grounds that a “security of supply payment” has not been, or will not be, paid by the Northern Ireland TSO/supplier for a period which is outside the period of the requested capacity booking.”

12. The letter of referral explained that such a charge “would be on the same basis as that imposed on customers in Ireland for the corresponding security of supply benefit accruing to Ireland from IC2 ... [and] based on, and proportionate to, the security of supply benefit deemed to accrue to Northern Ireland customers from access to IC2”. It did not provide other details of the proposed tariff.

13. On 19 October 2011, the Commission provided an answer. It concluded that:

“A fair proportion of the costs associated with ensuring security of supply benefits can be reflected in the tariffs associated with transporting gas to Northern Ireland from Ireland approved by the Commission for Energy Regulation. Provided it can be justified and does not lead to arbitrarily higher tariffs, the Irish transmission system operator may also reflect these security of supply benefits in the difference between tariffs for long and short term capacity. However, it is not possible to place an ongoing charge on a system user who may wish to only use the system on a small number of occasions as a precondition for access to the system...

In answer to the joint question set out in your letter, and based on the information since provided by the two regulatory authorities, DG Energy considers that it is not possible for the Irish national regulatory authority to approve a regulatory framework which would require Northern Ireland entities to pay an ongoing security of supply charge in order to have access to the Irish transmission system and to deny access to the Irish transmission system to Northern Ireland entities who have not paid this charge.”

14. As the letter goes on to note, the views that it expresses are not legally binding.

### *Current tariffs*

15. Gas that enters the Gaslink system at Moffat is subject to an entry tariff (“the Entry Tariff”). In the last two years when the CER set the Entry Tariff, it did so in the expectation that there would be no bookings for exit to the SNP. It therefore sought to make full recovery of the costs of the ICs through the Entry Tariff, namely €50m per annum. The CER has explained that in principle it seeks to recover the revenues needed to operate the ICs from two revenue streams: the Entry Tariff and the Exit Tariff. Nevertheless, in the absence of any expected bookings for exit to the SNP, it seeks to make full recovery through the Entry Tariff.

16. In the event that bookings were to be made to ship gas to Northern Ireland over the SNP, the Entry Tariff would be payable in addition to the Exit Tariff. The CER would apply a K factor to the tariff for the following year to reflect any over recovery arising out of tariff revenue it had received.

17. The Exit Tariff is set out and explained in a Decision Paper published by the CER on 27 July 2012 (“the Decision Paper”). It explains that the CER's objective is "to ensure that SNP shippers contribute proportionately to the costs and benefits of IC2 and the onshore Scotland system." As the Decision Paper explains:

"The methodology involves a calculation of the annual required revenue associated with IC2 and seeks to allocate this ongoing cost (circa €21.25m) pro rata to the maximum supply which may be made available to shippers in Ireland (€16.420m) and to shippers on the SNP (€4.829m)."

18. As already noted, the CER does not anticipate any bookings to ship gas to Northern Ireland over the SNP. In calculating the tariff, it has set a “Default Daily Tariff” that applies in the absence of any forecast bookings. The practical effect is that if gas was shipped to Northern Ireland over the SNP for ten days at full capacity, the full contribution of €4.289m sought towards the costs of IC2 would be recovered.

19. An exit tariff is payable wherever gas leaves the Gaslink System. In the case of gas shipped over the ICs for onward distribution within the Republic of Ireland, there is no exit tariff payable at the point that gas leaves the ICs at Gormanston as the gas remains within the Gaslink system. Thus, to use a simplified example, if gas is shipped from Moffat to Dublin then the Entry Tariff will be payable which contributes to the cost of the ICs at Moffat and an exit tariff will be payable that seeks to recover costs of the infrastructure from Gormanston to Dublin.

## **The arguments of the UR and the CER**

20. In a letter of 23 November 2012, the UR has raised four objections to this tariff:
21. Discrimination and cross-subsidy: security of supply principles have been used to apply the IC standby cost only at the Gormanston exit point, and not at any other exit point within the Republic of Ireland. As a result, there is an additional charge (over and above the usual IC charge only payable at Gormanston). The consequence is that a Northern Ireland shipper will pay more for using the ICs than a shipper in the Republic of Ireland, and yet receives substantially less security of supply benefit from the IC system compared to a Republic of Ireland shipper. The UR contends that this amounts to a cross-subsidy.
22. Cost reflectivity: the UR argues that the Exit Tariff is not reflective of the costs of Northern Ireland shippers using IC2, but has been based instead on a proportion of the overall revenues required for the IC system. The SNP only connects to IC2, and not IC1. Moreover, the effect is that NI shippers have to pay IC costs twice, as they already have to pay the Entry Tariff. Such a high tariff raises concerns about its impact on emergency situations.
23. Transparency: the methodology is not transparent and results in arbitrary tariffs as it appears that no analysis of the security of supply benefits for NI has been carried out. Moreover, CER has made clear that capacity has not been reserved for NI and may not be available on a peak day.
24. Facilitate efficient gas trade and competition: NI shippers have already pointed out that they do not intend to use the SNP due to the high costs of using the entry point. The tariff could lead to perverse investment decisions in the long, ie: additional pipelines or capacity.

25. The CER replied on 8 February 2013. It made the following general points:

- a. Northern Ireland consumers obtain a security of supply benefit from the IC whether or not they use it. The Commission made clear that security of supply could be taken into account in tariffs.
- b. The Regulator had a discretion to choose to recover the cost from those who actually use the assets, even if as a result the charges are higher than would be the case if all potential users were required to finance it.
- c. In practice all consumers in the Republic of Ireland pay the IC tariff because the Irish wholesale gas price is determined by the GB NBP price plus the cost of transporting the gas across the ICs so that all shippers can and will price up to that market clearing price.
- d. There is no ongoing security of supply charge for access to the Irish transmission system.
- e. Charges are based on cost considerations, rather than the benefits to users.
- f. To charge “pay when you use” Northern Ireland shippers the same unit tariff as “pay whether or not you use” Republic of Ireland shippers would amount to unfair discrimination.
- g. Given the low expected usage of this “standby” exit point, it is likely that such a tariff will be higher than tariffs that will apply at other “non standby” or “captive” exit.

26. As to the specific points set out in the UR’s letter of 23 November 2012, the CER gave the following response.

27. Security of supply : the starting point for the tariff is the costs of “standby operation”: ie 17 mscm/d – the capacity of IC1. Those costs are pro-rated by  $5/(17+5)$  to the SNP exit.

28. Discrimination and cross-subsidy: producers at other entry points (eg Inch) argue they provide security of supply and are remunerated by the ability to price up to the market

clearing price. Thus, all customers and shippers in the Republic of Ireland pay the same price.

29. Cost reflectivity: the allocation of costs of security of supply attributed to Northern Ireland and the Republic of Ireland is based on the respective maximum capacities that may be called upon by Northern Ireland and Republic of Ireland shippers. The supposed “double counting” is “nothing more than a function of unanticipated short term bookings in the context of an ex ante tariff setting methodology.” It is not uncommon for the cost of infrastructure used only in emergencies to be high.

30. As to the possibility of perverse investment decisions, there is nothing perverse about allocating a fair proportion of the costs associated with ensuring security of supply benefits in the tariffs associated with transporting gas to Northern Ireland from Ireland.

### **Legislative framework**

31. In 2009, the European Union adopted the so-called Third Energy Package of directives and regulations concerning the internal markets for gas and electricity ("the Third Package"). Specific provisions concerning gas transmission are contained in Directive 2009/73/EC concerning common rules for the internal market in natural gas ("the Gas Directive"), and Regulation (EC) No. 715/2009 on conditions for access to the natural gas transmission networks ("the Access Regulation") .

### **The Gas Directive**

32. Recital 1 describes the role of the internal market, including cross-border trade, and its contribution to security of supply:

"The internal market in natural gas, which has been progressively implemented throughout the Community since 1999, aims to deliver real choice for all consumers

of the European Union, be they citizens or businesses, new business opportunities and more cross-border trade, so as to achieve efficiency gains, competitive prices, and higher standards of service, and to contribute to security of supply and sustainability." (emphasis added)

33. Article 13(2) sets out an obligation on Transmission System Operators ("TSOs") to invest in sufficient cross border capacity:

"Each transmission system operator shall build sufficient cross-border capacity to integrate European transmission infrastructure accommodating all economically reasonable and technically feasible demands for capacity and taking into account security of gas supply." (emphasis added)

34. Article 32 sets out the requirement for third party access to the transmission system:

"(1) Member States shall ensure the implementation of a system of third party access to the transmission and distribution system, and LNG facilities based on published tariffs, applicable to all eligible customers, including supply undertakings, and applied objectively and without discrimination between system users. ...

(2) Transmission system operators shall, if necessary for the purpose of carrying out their functions including in relation to cross-border transmission, have access to the network of other transmission system operators." (emphasis added)

### **The Access Regulation**

35. Recital 19 of the Access Regulation sets out the general principle of an entry-exit system:

"To enhance competition through liquid wholesale markets for gas, it is vital that gas can be traded independently of its location in the system. The only way to do this is to give network users the freedom to book entry and exit capacity independently, thereby creating gas transport through zones instead of along contractual paths." (emphasis added)

36. Article 13 sets out certain requirements as to tariffs, and makes clear that recoverable costs can take account of the need for system integrity, which will include the cost of guaranteeing security of supply:

"(1) Tariffs, or the methodologies used to calculate them, ... shall be transparent, take into account the need for system integrity and its improvement and reflect the actual costs incurred ... Tariffs, or the methodologies used to calculate them, shall facilitate efficient gas trade and competition, while at the same time avoiding cross-subsidies between network users ... Tariffs for network users shall be non-discriminatory and set separately for every entry point into or exit point out of the transmission system ... network charges shall not be calculated on the basis of contract paths. ...

(2) Tariffs for network access shall neither restrict market liquidity nor distort trade across borders of different transmission systems." (emphasis added)

37. Article 14 makes provisions for availability of both short term and long-term services and their relative pricing:

"(1) ... (c) offer to network users both long and short-term services. ...

(2) Transport contracts signed with non-standard start dates or with a shorter duration than a standard annual transport contract shall not result in arbitrarily higher or lower tariffs that do not reflect the market value of the service, in accordance with the principles laid down in Article 13(1)." (emphasis added)

### **Security of Supply Regulation**

38. Regulation (EU) No 994/2010 concerning measures to safeguard security of gas supply ("The SoS Regulation") sets out the policy behind and requirements for emergency planning and minimum infrastructure requirements in the light of security of supply considerations. The guiding principles behind the SoS Regulation are solidarity between Member States, and a reliance as far as possible on market mechanisms of a functioning internal market for coping with disruptions to supply.

39. Recital 12 states:

"For a well functioning internal gas market it is essential that measures taken to safeguard the security of gas supply do not unduly distort competition or the effective functioning of the internal gas market." (emphasis added)

40. Recital 20 explains further:

"This Regulation should enable natural gas undertakings and customers to rely on market mechanisms for as long as possible when coping with disruptions. It should also provide for emergency mechanisms to be used when markets alone are no longer able to deal adequately with a gas supply disruption. Even in an emergency, market-based instruments should be given priority to mitigate the effects of the supply disruption." (emphasis added)

41. Recital 22 adds:

"... a comprehensive and effective common approach to security of supply is required, particularly transparency, solidarity and non-discriminatory policies compatible with the functioning of the internal market, avoiding market distortions and the undermining of market responses to disruptions." (emphasis added)

42. Infrastructure requirements are set out in Article 6, which requires inter alia sufficient capacity in infrastructure sufficient to guard against "disruption of the single largest gas infrastructure", and prescribes that all cross-border interconnections between Member States are to have bi-directional capacity.

### **Analysis**

43. In my view the CJEU would be likely to hold the Exit Tariff to be unlawful. I recognise the force of the essential point made by the CER: Northern Ireland shippers and consumers enjoy a security of supply benefit even where no gas is shipped to Northern Ireland over the ICs and SNP. The CER has not imposed a standing charge for security

of supply, but has instead sought to recover a pro-rated contribution to the costs of the ICs in the form of the Exit Tariff, payable only when and if IC2 is used to ship gas to Northern Ireland via the SNP.

44. The central reason why I consider this approach to be contrary to EU law, however, is that the practical effect of the way in which the CER sets its tariffs is that Northern Ireland shippers<sup>3</sup> pay two sets of contributions to the costs of operating the ICs whereas shippers transporting gas from Moffat and serving consumers in the Republic of Ireland pay only one. The Entry Tariff, payable at Moffat by all such shippers (irrespective of final destination) is calculated so as to recover the full cost of operating the ICs. Shippers who also pay the Exit Tariff then pay an additional set of contributions to that cost.

45. Whilst any over-recovery of costs of the IC may lead to the application of a K factor in the following year, it nevertheless remains the case that a shipper which has transported gas from IC2 into the SNP in a particular year will have paid two sets of contributions to the costs of the ICs, whereas a shipper that transports the same quantity of gas over IC2 for onward distribution within the Republic of Ireland will only pay one such contribution.

46. In my view, this central objection can be characterised in EU law in a number of ways. The Exit Tariff gives rise to discrimination amongst shippers: shippers to Northern Ireland pay an exit charge which imposes a second set of contributions to the cost of the IC, whilst shippers to destinations within the Republic of Ireland do not.<sup>4</sup>

47. Such discrimination is capable of being justified if proportionate to a legitimate aim. The justification advanced is essentially to obtain a fair contribution to the cost of security of supply from Northern Ireland shippers.

---

<sup>3</sup> I.e. shippers who transport gas from Moffat to Northern Ireland via the IC and SNP.

<sup>4</sup> It may potentially involve indirect nationality discrimination.

48. In my view the CJEU would be likely to hold the justification to be insufficient to impose a higher charge for security of supply at one particular exit point than at any other, based on a second set of contributions to the cost of the IC.

49. Moreover, in order to avoid over-recovery, the Entry Tariff is set in part by reference to the revenue raised (or expected to be raised) by the Exit Tariff. Article 13(1) requires tariffs to be "set separately for every entry point into or exit point out of the transmission system". That reflects the charging model by way of zones rather than contractual paths, as set out in recital 19. Thus, it might also be said that the Exit Tariff is based on the costs of a particular contractual path to that exit point, given that the Exit Tariff seeks to recover the cost associated with transport of gas along a specific path from Moffat *via* IC2 to Gormanston.

50. Overall I consider that the CJEU would conclude that the imposition of an additional tariff could not be justified in those circumstances.

51. It might be objected to this analysis by the CER that it gives rise to a problem of free-riding: Northern Ireland shippers and consumers continue to enjoy a security of supply benefit even when no gas is shipped from IC2 to SNP. In my view there are two answers to this. First, such "free-riding" may also occur in the Republic of Ireland by customers who are not charged an additional contribution to the cost of IC to reflect of security of supply.<sup>5</sup> By way of example, an industrial installation that needs only occasional access to gas supplies also enjoys a security of supply benefit at other times.<sup>6</sup> Secondly, the Exit Tariff in any event does not impose a charge upon all "free-riding" users. Instead, it imposes an additional charge on those who actually do make use of this facility, that is not based upon the costs of security of supply enjoyed by that particular user.

---

<sup>5</sup> For the avoidance of doubt, I do not suggest such free riding is illegal, but rather that the possible scope for free-riding does not justify the terms of the Exit Tariff.

<sup>6</sup> One might envisage a site that has gas storage facilities, or has alternative sources of power.

52. As to the question of cost reflectivity, there is clearly a sense in which the Exit Tariff is reflective of costs: it is designed to recover a proportion of the costs of operating the ICs. Moreover, the CER enjoys a measure of discretion in how it fixes prices on the basis of costs.<sup>7</sup> As already noted, the purpose of this charge is contribute to the cost of security of supply. The difficulty, however, is the effect is to levy a higher charge for security of supply at one particular exit point, based on a second set of contributions to the cost of the IC.

53. In my view, there are other ways in which this central objection may be characterised. The Exit Tariff also serves to “distort trade across borders” and to distort competition: Art 13 of the Access Regulation. I recognise that the economics of shipping gas to Northern Ireland via the ICs are such that such an export is uneconomic in any event, but in my view that is not a complete answer to the point. The presence of the Exit Tariff nevertheless serves to alter investment incentives in Northern Ireland and may potentially render more attractive alternative sources of supply which may be otherwise less efficient.

54. More generally, I consider that the CJEU would take the view that the imposition of the Exit Tariff is in tension with the broad aims of the relevant legislative provisions I have set out above: to facilitate cross border trade and security of supply.

55. Outside the scope of the Third Package, the Exit Tariff might fall to be construed as a measure having the equivalent effect to a quantitative restriction on exports, contrary to Article 35 TFEU.<sup>8</sup> Such a measure is capable of justification pursuant to Article 36 TFEU, but must restrict intra-EU trade no more than is absolutely necessary.<sup>9</sup> For essentially the reasons already set out, I do not think that such a justification would be made out in this case.

---

<sup>7</sup> Case C-438/04 *Mobistar* [2006] ECR I-6675, para 34.

<sup>8</sup> See eg Case C-388/95 *Belgium v Spain* [2000] ECR I-3123 para 41. In the alternative, it also seems at least possible to me that the Exit Tariff might fall to be considered a measure equivalent to an export duty contrary to Article 30 TFEU: Case 24/68 *Commission v Italy* [1969] ECR 193. Given the conclusions I have reached in this Advice I have not conducted the legal research necessary to reach a concluded view on that question.

<sup>9</sup> See, eg Case 72/83 *Campus Oil v Minister for Industry and Energy* [1984] ECR 2727 para 31.

## **Conclusion**

56. I accordingly conclude that the CJEU would be likely to conclude that Exit Tariff is not compatible with EU law. A definitive answer to this question can of course only be obtained by means of a reference to the CJEU itself.
57. I do not consider that it is unlawful in principle to apply *any* exit tariff in respect of gas that exits the Gaslink system at Gormanston. Any such tariff must, however, comply with EU law.
58. Nor do I seek to take issue with the Commission's view that a "fair proportion of the costs associated with ensuring security of supply benefits can be reflected in the tariffs associated with transporting gas to Northern Ireland". For the reasons already given, however, I do not consider the present tariff arrangements to be a lawful means to achieve this.

TIM WARD Q.C.

MONCKTON CHAMBERS

GRAY'S INN

2 AUGUST 2014