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The International Comparative Legal Guide to: Gas Regulation 2012

A practical cross-border insight into Gas Regulation work

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Investing in European Regulated Gas Infrastructure: A Favourable Legal Environment?

Dechert LLP

René H. Gonne

Wim Vandenberghe

Introduction

The European gas industry, as well as EU policy makers and national energy regulators, are facing challenging times. One of them is how to guarantee gas supplies to and within Europe for the decades to come and this within increasingly liberalised markets. To face this challenge, massive investments will be needed in gas infrastructure. Whilst securing financing and the general state of the economy are typical drivers when taking such investment decision, there is an extra issue to be taken into account by potential investors in Europe, and that is EU energy regulation. **Wim Vandenberghe** and **René Gonne**, lawyers at Dechert LLP in Brussels, consider the EU regulatory framework that governs gas infrastructure investments with both its pitfalls and opportunities.

Gas Infrastructure Needs in Europe

Aside from the need for power plants investments, the European Commission's Energy Infrastructure Package of November 2010, and subsequent strategy documents in 2011, called for a new EU energy infrastructure policy to coordinate and optimise future energy network development on a pan-European scale.

The years 2000-2011 saw considerable development of new gas storages and LNG terminals, with an upward trend throughout the period. Also several new import pipelines are finally coming online (North and South Stream, Blue Stream-2 and Nabucco may materialise soon too), but additional export capacity will still be required. Gas interconnectors, linking EU Member States, have in particular developed slowly. This lack of new and well-interconnected gas infrastructure poses high risks in terms of gas disruptions, congestion and wastage. Market problems may also arise when there are not enough bi-directional pipelines (e.g., in January of 2009 the lack of reverse flow pipelines in Eastern Europe caused serious disruptions). New interconnectors between countries are also needed to facilitate competition and to create liquid and integrated regional markets. As the markets subsequently become increasingly liberalised, spot markets may grow and that requires more short-term gas storage, which is in turn commercially beneficial to shippers. Enhanced (underground) gas storage capacities are also required in view of EU Member States, transmission system operators (TSOs) and gas undertakings, their obligations under the EU security of supply regulations. TSOs are also obliged under the EU Third Energy Package to submit each year to the national energy regulator a Ten-Year Network Development Plan (TYNDP), containing efficient measures guaranteeing the adequacy of the gas system and security of supply. This TYNDP should be consistent with the EU-wide TYNDP, elaborated and adopted in the framework of the European Network of TSOs for gas (ENTSO-G), with a focus on cross-border interconnections.

In its report to the European Council in February 2011, the European Commission has estimated that the investment needs up to 2020 in high pressure gas transmission pipelines (coming into the EU and between EU Member States), storage, liquefied and compressed natural gas (LNG/CNG) terminals and reverse flow infrastructure to be approximately EUR 70 billion. The 2011 TYNDP considers investment needs even to be at EUR 89 billion. Whereas certain priority projects may be co-financed by the EU in view of particular regional or EU-wide security of supply or solidarity issues (see further), it is clear that the gas industry will be called upon to invest in new infrastructure and in the improvement of the existing one.

In view of the scale in both investment amount and the urgency to deliver the required energy infrastructure by 2020, many TSOs, especially in eastern European Member States, will reach the limits of their financing capacity. As a general rule, if a project lies within the TSO's service area and is mainly linked to domestic gas transmission or distribution, TSOs will use corporate financing. Project financing is typically used for larger, specific projects such as LNG terminals, storage, merchant pipelines or complex joint ventures. Several TSOs will in any case need large equity injections by private investors or public owners to be able to contract more debt for their future investment programmes. In addition, TSOs may increasingly face difficulties with accessing long-term debt on favourable terms following the financial crisis. On the other hand, institutional investors such as pension funds, insurance companies and wealth funds, increasingly move into infrastructure assets given its potential to match provide diversification, a long investment horizon and steady revenue streams.

Whether the financiers of gas infrastructure are TSOs, banks, private or public investors, institutional investors and so on, they all have in common that they expect a stable, coherent and attractive regulatory framework to govern gas investments in the long-term.

To Fully Regulate or to Exempt … or to Mix-up

At European level, the regulation of gas infrastructure is governed primarily by the Gas Directive 2009/73/EC and by the Gas Regulation 715/2009. There are in principle two different regulatory regimes for gas infrastructure investment: the fully regulated approach; and the merchant-exempt approach.

The *fully regulated approach* is the default position under EU regulations and means that gas transmission and distribution networks, cross-border interconnectors, gas storage and LNG terminals are subject to regulated third party access (rTPA; though

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for storage facilities the Member States can opt for a negotiated access model which gives more flexibility), unbundling obligations, prior approval of tariffs by national regulatory authorities (including specific conditions for the use of revenues) and compliance with the congestion management guidelines. The rTPA first of all often poses problems for the investor consortium, as it means that the consortium cannot have full capacity underwritings (for example, the owners of a pipeline or an LNG terminal are required to open and share access with third parties granted with access rights under transparent and non-discriminatory conditions). Secondly, the revenues which the consumers pay (through the usage tariffs) and which the investors use to finance the investment, are in several countries cost-based (typically in the form of rate-of-return and cost-plus regulation). This regulatory remuneration does provide legal certainty as investors receive a standard regulated return, but this is often regarded as an investment barrier due to low rates on return (though certain national regimes allow for a bonus system). Providing appropriate remuneration for investors and infrastructure operators is, however, key and ensures the viability of the gas infrastructure which is required by shippers. In that respect, it is also important to note that congestion rents need to be passed on to the customers or invested in new interconnection capacities under the EU regulations (rather than appertaining freely to the investors). The inconsistency between the different national remuneration schemes – one being fairer than the other – is detrimental for existing or new investors in gas assets.

The *merchant-exempt approach* is designed to allow for new investments presenting a high level of risk, which would not have taken place unless an exemption was granted. If new infrastructure is exempted, it is not submitted to all or part of the unbundling requirements, rTPA rules or regulated tariffs (incl. obligation for allocation of revenues to maintaining/upgrading interconnector capacity). Investors will thus not receive any regulated returns on their investment and are exposed to the full upside and downside of their investment in function of market conditions and the arising congestion rents. The exemption can be either limited or full (exemption from only a part or from all of the obligations imposed by the regulated regime) and it can relate to the entire infrastructure or part of it. New infrastructure projects will be exempted if they meet the following criteria:

- the investment must enhance competition in gas supply and enhance security of supply;
- the level of risk attached to the investment is such that the investment would not take place unless an exemption was granted;
- the infrastructure must be owned by a natural or legal person which is separate at least in terms of its legal form from the system operators in whose systems that infrastructure will be built;
- charges are levied on users of that infrastructure; and
- the exemption is not detrimental to competition or the effective functioning of the internal gas market, or the efficient functioning of the regulated system to which the infrastructure is connected.

The merchant-exempt route does not bring full solace to investors though. This mainly has to do with the exemption criteria, which are open to a number of interpretations and are, not surprisingly, applied differently by national energy regulators. Another risk associated with the exemption process is that the exemption is often granted under certain stringent conditions, which may even make the project no longer viable. Finally, even if the national energy regulator approves the exemption, then this can ultimately still be overruled with additional conditions or even prohibited by the European Commission, as demonstrated in 2011 by the fact that the Czech authorities were obliged to withdraw their 2010 notified decision to exempt an underground gas storage facility in Dambořice, Czech Republic after the European Commission took the view that not all the above exemption criteria were fulfilled. So securing an exemption is becoming increasingly difficult and sometimes not even desirable from a regulatory viewpoint (e.g. due to imposed conditions) or market viewpoint (e.g. due to limited congestion rents).

An alternative approach to the fully regulated and merchant regimes is the *"incentive-based" regulation*, also nicknamed the "regulated+" regime. This regime aims at more efficient risk management for investors and bringing down the cost of capital, while protecting consumers from exposure to high level of risks. Regulators have a clear obligation under the EU Third Energy Package to ensure that the tariffs provide appropriate return on investments and that there are sufficient incentives to construct new gas infrastructure. There is a lot of discretion left to EU Member States when using these incentive schemes in their national regulatory framework, as long as it remains compliant with the EU gas directives and regulations. France and Italy for example give explicit incentives for congestion reduction and cross-border investments. The UK allows investments remunerated "as spent", i.e. work in progress can earn a return or financing costs otherwise recovered before assets are completed and enter into operation. Other ways to promote investments are long-term commitments in the booking of capacities to limit risk for infrastructure; rewarding higher risks projects (e.g. cross-border or offshore infrastructure) through premium rate of return, shortened amortising period, etc. As a result, the features and application of an incentive-based investment regulation vary among Member States.

Bridging Different Regulatory Investment Regimes

Especially for cross-border infrastructure, there is a risk that differences between two national regimes (fully regulated; merchant-exempt or "regulated+") on both sides of the interconnector, for example, may result in asymmetric interests for investors involved in the shared infrastructure project. Regulators are now required to not only cooperate with other regulators but also with the TSOs on cross-border issues in particular. This means they should not evaluate investments solely on the basis of benefits in their Member State, but on the basis of EU-wide benefits. The national regulators should also ensure the consistency of their legal and regulatory framework and facilitate market integration. Regulators are therefore launching more and more often joint consultations, which set out the rationale and key parameters for seeking a coordinated solution in order to indeed develop a predictable and stable framework that facilitates gas infrastructure investment. Another way of creating more comparability and transparency for investors is by the ongoing work on drafting framework guidelines and network codes within the new agency for the cooperation of energy regulators (ACER), based in Slovenia. Examples are the envisaged framework guidelines regarding harmonised transmission tariff structures and regarding congestion management procedures which may create a more liquid gas market without the physical expansion of the network.

Furthermore, from a regulator's standpoint, ACER should guarantee the effective cooperation between national regulators, for the exemption of cross-border investments. For example, in case the concerned national regulators do not come to an agreement with regard to an exemption request, then ACER is to take the final decision. ACER can also decide if the concerned national regulators mandate ACER thereto.

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Ready, Set, Go?

Lead times from the conception to the realisation of major gas infrastructure projects always takes several years, but in Europe this has been even further delayed by long and uncertain permit granting procedures. The main reasons for the delays in the authorisation or permit procedures comprise the complex and non-transparent procedures and the public opposition (NIMBY or BANANA). In addition, whilst the legislative framework for authorisation procedures and environmental impact assessment in EU countries is similar, the implementation thereof in national law differs. The main risk of all these permitting issue is that potential lenders and investors will be reluctant to provide the required funds (as it implies a longer period of time until regulatory or merchant revenues are generated).

The European Commission published on 19 October 2011 a proposal for a Regulation on guidelines for trans-European energy infrastructure. This aims at overhauling the existing framework with regard to TEN-E (trans-European energy networks). As regards gas infrastructure projects of common interest (i.e. North-South gas interconnections in Western Europe, North-South gas interconnections in Central Eastern and South Eastern Europe, Southern Gas Corridor, Baltic Energy Market Interconnection Plan in gas), the draft Regulation foresees the streamlining and speeding up of the permitting procedure, including a time limit for final decision. The permits would be granted within a maximum period of three years consisting of two phases, (i) the pre-application procedure (i.e. the period between the start of the permit granting procedure and the acceptance of the submitted application file by the competent authority), and (ii) the statutory permit granting procedure (i.e. the period between the submission of the application and the issue of the decision).

EU Financial Assistance

Even under an attractive regulated or merchant model, there may be gas infrastructure projects that are not commercially viable (this could be determined after conducting open season procedures to determine market interest via capacity auctions). This raises the question whether there is EU funding available.

Under the TEN-E framework, the EU has to date focused its financial support on funding feasibility studies and a small number of construction projects. The European Energy Programme for Recovery also co-financed important infrastructure projects that would otherwise have been delayed or cancelled due to the financial crisis. On 29 June 2011, the Commission adopted a proposal for the next Multi-Annual financial framework for the period 2014-2020. In its proposal, the Commission decided to propose the creation of a new integrated instrument for investing in EU infrastructure priorities in Transport, Energy and Telecommunications: the "Connecting Europe Facility". In the period 2014 – 2020, EUR 9.1 billion is earmarked for energy infrastructure under the proposed Regulation establishing the "Connecting Europe Facility" (CEF).

Beyond EU Borders

More than 60% of the gas consumed in the European Union is imported from third countries and this share is steadily increasing. These neighbouring countries, which are not EU Member States, are thus crucial as key producer or transit countries. Like the EU, they also face huge investments needs in terms of reinforcing or refurbishing existing gas infrastructure and constructing new capacity. These investments are required not only to safeguard the EU's security of supply but also the gas producers their security of demand. The gas infrastructure development outside the EU may well be governed by *EU energy acquis*, through the fact that the concerned country is a candidate country to the EU or through the country's membership of bilateral and multilateral instruments. An example of a multilateral co-operation is the Energy Community Treaty which groups since 2006 South East European countries in their attempt to create a regional integrated energy market, as well as a stable regulatory and market framework. These countries (which include for example Ukraine which is an important gas transit country) have committed themselves to liberalise their energy markets by implementing EU legal acts. In October 2011, the Ministerial Council decided that the parties of the Energy Community need to transpose the EU Third Energy Package into national law by January 2015. So investors in gas infrastructure assets across South East Europe will need to take account of the above-mentioned EU regulatory framework as well.

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