

**NOTE OF DG ENERGY & TRANSPORT ON DIRECTIVES
2003/54/EC AND 2003/55/EC ON THE INTERNAL MARKET
IN ELECTRICITY AND NATURAL GAS**

THIS DOCUMENT IS NOT BINDING ON THE COMMISSION

SECURITY of SUPPLY PROVISIONS for GAS

16.01.2004

1. INTRODUCTION

On 26 June 2003, the 2nd Internal Gas Market (IGM) Directive (Directive 2003/5/EC) was adopted. The new directive, which Member States shall implement into national legislation no later than 1 July 2004, contains a number of provisions with regard to security of gas supply. Some of these were already contained in the first directive while some are new and others have been reinforced. The objective of this note is to provide some guidance as to the understanding and interpretation of the measures of the 2nd IGM directive with regard to security of supply.

Pursuant to Art 2(32) of directive 2003/55/EC, "security" means both security of supply of natural gas and technical safety.

Security of supply provisions contained in the 2nd Internal Gas Market Directive have to be seen against the background of six different aspects which will be developed in this note.

1. Public Service Obligations (PSO), which could cover security of supply, i.e. security of supply obligations could be established in the framework of Public Service Obligations. Furthermore, long-term planning may be introduced in relation to security of supply.
2. Monitoring and reporting duties of the Commission and Member States.
3. Security of supply with respect to third party access to upstream pipelines.
4. Security of supply constituting a reason for granting an exemption from TPA rules to new major gas infrastructure.
5. Security of supply constituting a reason for refusing access to the network, if security of supply obligations form part or are defined as PSO.
6. Finally, the need to ensure security of supply should be taken into account, when deciding on certain derogations in relation to take-or-pay commitments.

Each of these aspects of security of supply as contained in the directive will be discussed below.

2. SECURITY OF SUPPLY AS PUBLIC SERVICE OBLIGATIONS

A separate document provides an analysis and interpretation of Public Services Obligations included in the 2nd Internal Gas Market Directive. The specific questions relating to Security of Supply for gas are examined in the following.

Pursuant to Article 3(2)

2. *Member States may impose on natural gas undertakings, in the general economic interest, public service obligations which may relate to security, including security of supply...Such obligations shall be clearly defined, transparent, non-discriminatory and verifiable. In relation to security of supply, and the fulfilment of environmental goals, including energy efficiency, Member States may introduce the implementation of long-term planning, taking into account the possibility of third parties seeking access to the system.*

...

4. *Member States shall implement appropriate measures to achieve the objectives of social and economic cohesion, environmental protection, which may include means to combat climate change, and security of supply. Such measures may include, in particular, the provision of adequate economic incentives, using, where appropriate, all existing national and Community tools, for the maintenance and construction of necessary network infrastructure, including interconnection capacity.*

In doing this, Member States shall have full regard to the relevant provisions of the Treaty and in particular Article 86, which, among other things, stipulates that

“undertakings entrusted with the operation of services of general economic interest...shall be subject to the rules contained in this Treaty, in particular to the rules on competition, insofar as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them.”¹

This would mean that the application of such rules, notably competition rules, must not actually prevent the undertakings concerned from performing the relevant tasks. So far, performing services of general economic interest would take precedence over competition rules. However, the 2nd sentence of Article 86(2) EC restricts the exemption from the application of such rules in that the

“development of trade must not be affected to such an extent as would be contrary to the interests of the Community.”

¹ Article 86 (2) sentence 1 EC

As a result, exempting undertakings fulfilling public service obligations from certain rules laid down in the Treaty, in particular competition rules, and in relation to the development of trade is limited to the extent that they run counter the interests of the Community.

In order to understand what is meant by the notion “interests of the Community”, it is helpful to look at Article 3(5). It states,

“The interests of the Community include, inter alia, competition with regard to eligible customers in accordance with this Directive and Article 86 of the Treaty”.

Hence, the interests of the Community in the sense of Article 86 EUT are clearly defined by competition with regard to eligible customers.

Furthermore, it is worth noting that according to the prevailing interpretation of Article 86 EC and notably Article 86(2) EC, the Commission on a case-by-case basis and in the light of the specific circumstances, would define the notion “interests of the Community” with respect to its essence and substance². It is also worth highlighting that Article 86(2) EC can only be relied upon “to the extent to which performance of the particular task assigned to (an) undertaking can be assured only through the grant of such (special or exclusive) rights”³.

The overall objective of the IGM Directive is the completion of the internal market, which necessitates the introduction and promotion of competition between market participants. This assessment is supported by recitals 1 to 4, which set the creation of an internal market for gas in the context of the Lisbon strategy set up by the European Council to achieve a fully operational internal market. Furthermore, recital 30 explicitly identifies the objective of the directive, namely “the creation of a fully operational internal gas market, in which fair competition prevails”.

Against this background, it is important that the completion of the internal energy market including competition and the development of trade in accordance with the Treaty must not be hampered or in any other way negatively affected by any means contained in that directive. Therefore, it is obvious that the implementation of security of supply obligations defined as PSOs must affect the development of trade and competition only in the least possible manner. One may assume that this is the case, if and as long as there is no alternative solution reasonably and economically available.

Contrary to electricity, gas supply can not be considered a universal service. If a Member State nevertheless decides to cover all or a certain segment of customers by PSO, such PSO should by no means negatively affect trade and consequently the development of competition, insofar these PSOs also concern customers who cannot be considered to rely exclusively on gas. In other words: where gas could economically and reasonably be replaced by an alternative fuel, PSOs should not constitute any grounds for the restriction of competition.

² Buendia, Sierra, José Luis, Exclusive rights and state monopolies under EC law: article 86 (formerly Article 90) of the EC Treaty, translated from the Spanish by Andrew Read, Oxford 1999, p 341ff

³ ECJ – TNT Traco, ECR 2001, 4109, rec. 52.

In principle PSOs related to security of supply should in any case be restricted to customers who are unable to switch to an alternative fuel or who do not have own security of supply means available. It is important to note that even in such cases competition must only be restricted to the least extent possible. As a benchmark, whether a concrete measure or standard under the PSO umbrella for security of supply might be appropriate, similar and corresponding measures in place in other Member States may serve as a reference.

3. MONITORING AND REPORTING DUTIES OF THE COMMISSION AND MEMBER STATES

Relevant provisions of the Directive

Article 5

Monitoring of security of supply

Member States shall ensure the monitoring of security of supply issues. Where Member States consider it appropriate, they may confer this task to the regulatory authorities referred to in Article 25(1). This monitoring shall, in particular, cover the supply/demand balance on the national market, the level of expected future demand and available supplies, envisaged additional capacity under planning or construction, and the quality and level of maintenance of the networks, as well as measures to cover peak demand and to deal with shortfalls of one or more suppliers. The competent authorities shall publish, by 31 July each year at the latest a report outlining the findings resulting from the monitoring of these issues, as well as any measures taken or envisaged to address them and forward this report to the Commission forthwith.

Article 31

Reporting

1. The Commission shall monitor and review the application of this Directive and submit an overall progress report to the European Parliament and the Council before the end of the first year following the entry into force of this Directive, and thereafter on an annual basis. The report shall at least cover:

...

- (d) *an examination of issues relating to system capacity levels and security of supply of natural gas in the Community, and in particular the existing and projected balance between demand and supply, taking into account the physical capacity for exchanges between areas and the development of storage (including the question regarding proportionality of market regulation in this field);*
- (e) *special attention will be given to the measures taken in Member States to cover peak demand and to deal with shortfalls of one or more suppliers.*

More detailed information about the appropriate structure and the necessary data will be provided at a later date.

4. SECURITY OF SUPPLY WITH RESPECT TO THIRD PARTY ACCESS TO UPSTREAM PIPELINES

Relevant provisions of the Directive

Article 20

Access to upstream pipeline networks

...

2. *The access referred to in paragraph 1 shall be provided in a manner determined by the Member State in accordance with the relevant legal instruments. Member States shall apply the objectives of fair and open access, achieving a competitive market in natural gas and avoiding any abuse of a dominant position, taking into account security and regularity of supplies, capacity which is or can reasonably be made available and environmental protection.....*

According to Article 20(2), Member States who have upstream networks may take into account security of supply when designing the access regime to upstream networks. This could concern certain capacity requirements that may be imposed on the operator of the upstream pipelines, i.e. to make the necessary capacity available in order to meet demand under certain conditions. However, it is important that such security of supply obligations would not mean to deprive the market permanently of a proportion of the capacity of upstream pipelines. On the contrary, the capacity should be offered on interruptible terms with well-defined criteria for interruption.

5. SECURITY OF SUPPLY CONSTITUTING A REASON FOR GRANTING AN EXEMPTION FROM TPA RULES TO NEW MAJOR GAS INFRASTRUCTURE

Relevant provisions of the Directive

Article 22

New infrastructure

- (1) *Major new gas infrastructures, i.e. interconnectors between Member States, LNG and storage facilities, may, upon request, be exempted from the provisions in Articles 18, 19, 20, and 25(2), (3) and (4) under the following conditions:*

- (a) *the investment must enhance competition in gas supply and enhance security of supply;*

...

- (2) *Paragraph 1 shall apply also to significant increases of capacity in existing infrastructures and to modifications of such infrastructures which enable the development of new sources of gas supply.*

Article 22(1) lit a may contribute to constituting an exemption from certain rules of the IGM directive, including third party access to major new gas infrastructures, if the investment will “enhance security of supply”.

Article 22(1) identifies major new infrastructure as

1. interconnectors between Member States,
2. LNG facilities and
3. storage facilities.

Ad 1. The notion “interconnector” is defined in Article 2(17) as

“a transmission line which crosses or spans a border between Member States for the sole purpose of connecting the national transmission systems of these Member States.”

Diversification of supply routes and supply sources represents an important means of enhancing security of supply⁴. Hence, an interconnector as defined in Article 2(17), could contribute to security of supply in that it may bring about new supply sources to the markets of at least one of the Member States concerned and/or would diversify supply routes of at least one of the Member States concerned.

Subject to more detailed analysis on a case-by-case basis, a new interconnector is in principle likely to meet the security of supply criterion embedded in Article 22(1) lit a. However, it is important to note that enhancing competition (albeit not treated here) has to be equally considered in this context (see paper on “Treatment of new infrastructure and other instruments”).

Ad 2. The construction of new LNG facilities would usually increase the overall supply base of a market. They may be dedicated to new supply sources, thereby expanding the supply portfolio of the market concerned. Both aspects may contribute to increasing security of supply⁵. As a consequence, new LNG facilities could, in principle, be assumed to meet the security of supply eligibility criterion embedded in Article 22(1) a. Here as well, it is important to note that enhancing competition also needs to be considered.

Ad 3. Storage facilities are very important instruments in terms of security of supply. There are different types of storage facilities serving different purposes, depending on their size and capacity features (injection and withdrawal capacity, working volume etc). The need to consider competition aspects would also apply to storage facilities as for other types of new major infrastructure.

Article 22(2) extends the exemption provision of paragraph 1 also to

- significant increases of capacity in existing infrastructure and to
- modifications of such infrastructures which enable the development of new sources of gas supply.

⁴ This has also been acknowledged by the Green Paper of the Commission “Towards a strategy for security of energy supplies”.

⁵ However, due to the specific quality requirements of LNG, it cannot be assumed that each LNG source would be able to land at each LNG regasification terminal, unless the necessary technical facilities would be made available.

These extensions would have to fulfil the same criteria of article 22(1), which are detailed in the document ‘Applications of Exemptions from Regulated Third party Access for new gas and electricity infrastructure’.

6. SECURITY OF SUPPLY CONSTITUTING A REASON FOR REFUSING ACCESS TO THE NETWORK, IF SECURITY OF SUPPLY OBLIGATIONS FORM PART OR ARE DEFINED AS PUBLIC SERVICE OBLIGATIONS

Relevant provisions of the Directive

Article 21

Refusal of access

(1) Natural gas undertakings may refuse access to the system on the basis of lack of capacity or where the access to the system would prevent them from carrying out the public-service obligations referred to in Article 3(2) which are assigned to them or on the basis of serious economic and financial difficulties with take-or-pay contracts having regard to the criteria and procedures set out in Article 27 and the alternative chosen by the Member State in accordance with paragraph 1 of that Article. Duly substantiated reasons shall be given for such a refusal.

Article 21(1) constitutes a right to refuse access to the system where access would prevent natural gas undertaking from carrying out the public-service obligations imposed upon them. Insofar as PSO concern security of supply, refusal of access should not be authorised beyond what is needed to comply with proportionate and reasonable security of supply standards generally acknowledged across the European gas industry.

It is worth highlighting again that a clear and transparent definition of PSO on security of supply, as required by Article 3(2) is considered an indispensable prerequisite for refusal of access to the system on grounds of PSOs. If PSOs on security of supply are not in line with the requirements of Article 3(2), they cannot constitute grounds for refusing access to the system.

So far, the Commission has not been made aware of any request for refusal of access due to PSO related to security of supply.

Access to the network represents the core of the IGM Directives. For this reason, the criteria to refuse access to the system on the grounds of security of supply have to be applied in a restrictive manner.

As required by the last sentence of Article 21(1), “duly substantiated reasons shall be given for such a refusal”. Any PSO on security of supply requiring any derogation would at least need to be based on clear evidence that there is no reasonable and economically feasible alternative available, i.e. that granting access to the network would factually render it impossible to fulfil the PSO imposed on natural gas undertakings.

Security of supply requirements and obligations should not go beyond what is considered necessary and proportionate, including when benchmarked against security of supply requirements in other, similar markets. Member States going beyond such standards will need to substantiate the reasons, as otherwise, they may not comply with the overall objectives of Directive 2003/55/EC.

Furthermore, the considerations set out under chapter 1 above apply accordingly.

7. THE NEED TO ENSURE SECURITY OF SUPPLY SHOULD BE TAKEN INTO ACCOUNT, WHEN IT COMES TO DECIDING ON DEROGATIONS IN RELATION TO TAKE-OR-PAY COMMITMENTS

Relevant provisions of the Directive

Article 27

Derogations in relation to take-or-pay commitments

...

3. When deciding on the derogations referred to in paragraph 1, the Member State, or the designated competent authority, and the Commission shall take into account, in particular, the following criteria:

...

(b) the need to fulfil public-service obligations and to ensure security of supply;

When deciding on a derogation based on serious economic and financial difficulties because of take-or-pay commitments accepted in one or more gas-purchase contracts a natural gas undertaking encounters or considers it would encounter, Art 27(3)b requires the designated competent authority and the Commission to take account of, inter alia “the need to fulfil public-service obligations and to ensure security of supply”.

In this context, it is worth referring also to chapter 5 above. However, while chapter 5 may also be relevant due to the initiative of a (network or storage) system operator with PSO imposed, Article 27(3)b exclusively concerns a company with a take-or-pay contract (supply contract), as a result of which it may encounter serious economic and financial difficulties. Consequently, this company may ask its corresponding holding company (Mother Company) to instruct the relevant system operator to refuse access due to “serious economic and financial difficulties with take-or-pay contracts” facing the supply arm of the holding company.