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**OPINION OF THE AGENCY FOR THE COOPERATION OF ENERGY
REGULATORS No 03/2015**

of 18 June 2015

**ON THE COMPLIANCE OF THE DECISION OF THE NATIONAL
COMMISSION FOR ENERGY CONTROL AND PRICES OF THE
REPUBLIC OF LITHUANIA WITH THE GUIDELINES REFERRED TO IN
DIRECTIVE 2009/73/EC, REGULATION (EC) NO 715/2009 OR WITH
OTHER RELEVANT PROVISIONS OF THIS DIRECTIVE OR
REGULATION**

THE AGENCY FOR THE COOPERATION OF ENERGY REGULATORS,

HAVING REGARD to Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators¹, and, in particular, Article 7(4) thereof,

HAVING REGARD to 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 1775/2205², and, in particular, Article 13 thereof,

HAVING REGARD to 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/EC³,

HAVING REGARD to the Decision of the Agency for the Cooperation of Energy Regulators No 01/2013 of 29 November 2013 on the Framework Guidelines on rules regarding harmonised transmission tariff structures for gas,

HAVING REGARD to the favourable opinion of the Board of Regulators of 10 June 2015, delivered pursuant to Article 15(1) of Regulation (EC) No 713/2009,

Having given the National Commission for Energy Control and Prices of the Republic of Lithuania the opportunity to make known its views on the observations raised by the Agency,

WHEREAS:

¹ OJ L 211, 14.8.2009, p. 1.

² OJ L 211, 14.8.2009, p. 36.

³ OJ L 211, 14.8.2009, p. 94.

1. THE REQUEST

- (1) On 11 November 2014, the Agency for the Cooperation of Energy Regulators (hereinafter referred to as the 'Agency') received a request for an opinion pursuant to Article 7(4) of Regulation (EC) No 713/2009 of the European Parliament and of the Council of 13 July 2009 establishing an Agency for the Cooperation of Energy Regulators, from Valstybinė Kainų Ir Energetikos Kontrolės Komisija, the National Commission for Energy Control and Prices (i.e. the Lithuanian energy regulator, hereinafter referred to as the 'NCC'), concerning the compliance of Resolution No. O3-839 of 13 October 2014 of the NCC on the amendment of the Methodology for the Determination of National Regulated Prices in Natural Gas Sector (hereinafter referred to as the 'Decision'), with the Guidelines referred to in Directive 2009/73/EC, Regulation (EC) No 715/2009 and with other relevant provisions of those Directive or Regulation⁴.

2. THE DECISION

- (2) NCC adopted the Decision amending the methodology for the calculation of regulated transmission prices by moving from a Point-to-Point system to an Entry-Exit system. In particular, the Decision introduces a revenue cap regime to the cost allocation model for gas transmission pricing under the Entry-Exit system.
- (3) The Decision employs a pricing model which allocates costs to ensure that they can be recovered from each specific point in the system. According to the applied regime, a separate fee is charged to system users for both access to and exit from the system. The overall fee charged to system users is not related to a specific path.

2.1 *General regime and cost allocation methodology*

- (4) According to the revenue cap regime introduced by the Decision, the NCC sets the price at which capacity will be sold on the basis of capacity booking forecasts. Prices are set for a five years period (2014-18), with incentives, allowing for price adjustments. The chosen cost allocation approach is a matrix methodology with secondary steps (rescaling and equalisation).
- (5) Differences between forecasted and actual bookings are evaluated every year by the regulator, and prices may be adjusted accordingly⁵. Following incentive mechanisms, these prices may be further adjusted, depending on the evolution of a set of efficiency-based indicators⁶. The main inputs considered in the matrix methodology and for adjustments are, *inter alia*, inflation, volumes, investments, remuneration rates, technology, unforeseen changes, and exogenous factors to the regulated business⁷.

⁴ <http://www.acer.europa.eu/Media/News/Pages/ACER-calls-for-views-on-the-new-Lithuanian-gas-tariff-methodology-.aspx>

⁵ See art. 19.1.2 of the Decision.

⁶ See art. 20 of the Decision.

⁷ See the hearing presentation of NCC.

2.2 *Direct and Indirect costs*

- (6) Costs are deemed ‘direct’ if they can be objectively attributed to a specific transmission network segment. If, on the contrary, it is not possible to objectively relate costs to a specific network segment, these are deemed to be ‘indirect’. ‘Indirect’ costs are allocated to all the network segments, proportionately to the ‘direct’ costs. Direct costs are established on the basis of information provided by the Transmission System Operator Amber Grid (hereinafter referred to as ‘TSO’).
- (7) For the period 2014-18, based on a simplified representation of the Lithuanian gas transmission network (hereinafter referred to as ‘simplified network’), the ‘direct’ costs relating to specific transmission network segments (i.e. pipeline costs) represent 30% of the total allowed revenue. The ‘indirect’ costs, which are not attributed to a specific segment of the simplified network, represent 70% of total allowed revenue. The costs related to the part of the transmission network dedicated to domestic use are treated as “indirect costs” in the Decision.

2.3 *Entry/Exit split*

- (8) The Decision establishes that *“in making the calculations, the proportion of splitting the annual allowed revenues among the Entry and Exit Points is evaluated, which in general is 20/80”*⁸. In particular, NCC in its submissions explains that *“pursuant to the provisions of Item 17.4 of the Methodology and with an aim to create preconditions for entrance of new gas suppliers, development of the natural gas market, efficient use of alternative sources of natural gas supply, in calculating the price caps for entry and exit points, the proportion 20/80 is set for splitting the level of the allowable annual revenues among the entry and exit points”*⁹.

2.4 *Secondary adjustments*

- (9) The Agency notes that, following the allocation of the ‘direct’ costs according to the matrix methodology, NCC applies two secondary adjustments: a rescaling and an equalisation.
- (10) The rescaling consists of increasing or decreasing the initial tariffs for the entry and/or exit points. In order to ensure also the ‘indirect’ costs will be covered, the rescaling process applies a “normalisation” factor to the primary prices obtained¹⁰.
- (11) Equalisation results in the same tariff for a certain set of points in the system. Following equalisation, NCC allows that the TSO differentiates and groups transmission prices according to users’ characteristics, such as capacity booking, firmness of the product, consumption profile, and duration of the booking commitment¹¹.

⁸ See art 17.4 of the Decision.

⁹ See page 8 of the adjustment justification.

¹⁰ See 17.5 of the Decision.

¹¹ See art. 21 and 22 of the Decision.

3. TRANSMISSION OF GAS IN THE REPUBLIC OF LITHUANIA

- (12) The Lithuanian transmission network and its simplified representation, used as an input to the cost allocation methodology, are represented in Figure 11 below.

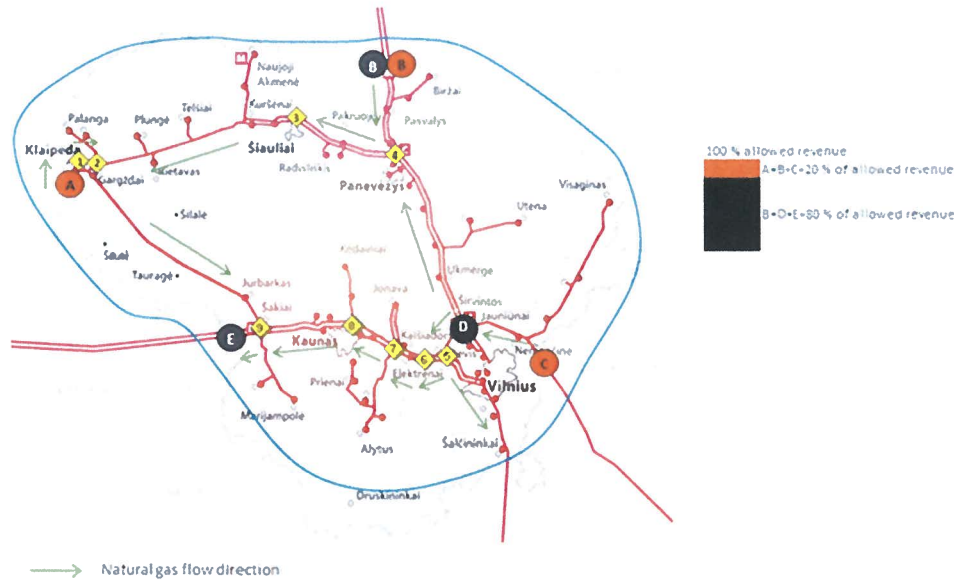


Figure 1: Transmission Network

A, B and C (orange) are entry points; B, D and E (black) are exit points; the network taken into account for the tariff calculation connects points marked from 1 to 9 (yellow).

- (13) The simplified network includes four interconnection points: i) Kiemenai, ii) Klaipėda, iii) Kotlovka, and iv) Sakiai. Kiemenai, located in the north of the country, is both an entry point into and an exit point from the system; Klaipėda, located in the west of the country, is an entry point from a LNG terminal commissioned in December 2014. In the south-east of the country, Kotlovka is an entry point from the Republic of Belarus. Finally, Sakiai, in the south-west of the country, is an exit point to the Russian Federation in the direction of the Kaliningrad region. All domestic consumptions are aggregated into a virtual exit point, located to the north of the capital Vilnius.
- (14) The main difference between the actual and the simplified network is that the latter includes the part of the transmission network that connects the abovementioned points, but excludes the secondary network (a series of segments referred to as “network branches”) that connect the primary network to distribution exits.
- (15) This secondary network is similar to the primary network in technical characteristic (comparable diameters and pressure levels) and ownership (as they belong to the TSO). They differ in use: while the primary network is used both for domestic consumption and transmission to neighbouring countries, the secondary network is dedicated to transporting gas to downstream users.
- (16) Part of the capacity associated to the pipeline that connects Kotlovka to Sakiai¹² is commercialised under a transportation contract between Amber Grid and Gazprom. It is described in the Decision as the “natural gas transmission from one third country to

¹² See Figure 11 above, respectively points C and E

*another third country through the territory of the Republic of Lithuania*¹³. While eventually this part of the transmission system will be regulated, it currently benefits from an exemption until December 2015, when the abovementioned contract ends.

4. ASSESSMENT

- (17) The Agency assessed the Decision in line with Regulation (EC) 715/2009 and Directive 2009/73/EC. In order to do so, the Agency also refers to the provisions of the Framework Guidelines on rules regarding harmonised transmission tariff structures for gas (hereinafter referred to as 'FG')¹⁴, setting out clear and objective principles as to how, according to the Agency, transmission tariff structures for gas should be defined.
- (18) The Agency mainly focuses on the allocation of indirect costs of the transmission system in the Decision, given the concerns this raises regarding its compliance with the above-mentioned legislation.
- (19) Pursuant to Article 13 of Regulation (EC) No 715/2009, tariffs for access to a transmission network must be calculated in line with the principles of transparency, system integrity, cost reflectiveness, non-discrimination and absence of cross-subsidies.
- (20) In this respect, as stated in the FG, there are three important steps in the calculation of tariffs: i) the definition of the inputs to the methodology, ii) the cost allocation methodology, and iii) secondary adjustments.
- (21) The first step consists in defining the parameters that reflect the costs in the system, such as a geographical representation of the assets in the network. The second step consists in choosing the relevant cost allocation methodology and feeding these parameters into the chosen cost allocation methodology. Ideally, the outcome of these two steps is the determination of tariffs to be applied at each point of the system in order to collect the allowed revenue. The third step allows for adjustments to ensure that the overall targeted allowed revenues are met and to simplify tariffing where relevant.
- (22) When defining parameters or selecting a cost allocation methodology, National Regulatory Authorities (hereinafter referred to as 'NRAs') or, where relevant, TSOs, typically face a trade-off between simplicity and stability of tariffs on the one hand, and tariff cost-reflectivity on the other hand.
- (23) While inputs that provide a higher level description of the costs lead to more stability, inputs that are more detailed lead to more cost-reflectivity.
- (24) Similarly, simplicity and stability are provided for by methodologies that involve more socialisation of the allowed revenue. Conceptually, in applying such methodologies, costs associated to the points in the system over which tariffs are equalised, are equally

¹³ See article 12.9.2.3.6 of the Decision.

¹⁴ Decision of the Agency for the Cooperation of Energy Regulators No 01/2013 of 29 November 2013 on the Framework Guidelines on rules regarding harmonised transmission tariff structures for gas.

allocated to these points. As clarified in the FG, the postage-stamp methodology typically allows such a scenario¹⁵. To the contrary, cost-reflectivity is provided for by methodologies that provide locational signals: the allowed revenue is shared among points in the system in a proportional manner with the costs triggered by the use of these points to enter or exit the system. As clarified in the FG, the matrix methodology typically provides such locational signals¹⁶.

- (25) It should be expected that, when facing the abovementioned trade-off, NRAs or, where relevant, TSOs, should determine an approach that is consistently applied to the inputs and the cost allocation methodology.
- (26) However, at the moment, while the Decision introduces a matrix methodology, the initial representation of the costs in the system takes only account of the 'direct' costs, associated to the primary network, representing only 30% of the total system costs. To the contrary, 'indirect' costs, associated to the secondary network and representing 70% of the allowed revenue, are allocated *pro rata* through the locational signals provided by the matrix methodology.
- (27) NCC justifies this approach on the basis of the circumstance that it is not possible, based on the origin of costs and on the simplified network, to allocate these costs to a specific segment in the system. NCC further explains that 'indirect' costs do not differ in technical characteristics and ownership from the 'direct' costs.
- (28) The Agency observes that the division between 'direct' and 'indirect' costs is based on choices made when defining the simplified network. Should a more detailed representation of the network be used, it would be possible to allocate at least part of the currently indirect costs to specific segments of the network. In addition, the Agency observes that the primary and the secondary network do not differ in technical characteristics and ownership, they differ in use.
- (29) Cost-reflective approaches to tariffs seek to charge system users according to their use of the system. As a result, when using the matrix methodology in association with a simplified network, there is a need to ensure an adequate representation of the costs in the simplified network.
- (30) In the case at hand, there is a discrepancy between the choice of the Decision for a matrix methodology, which *per se* requires cost reflectivity at a high level and accurate locational signals, and the lack of detail of the initial representation of the costs in the system resulting from the simplified network. In this regard, the exclusion of the secondary network from the direct costs lowers the accuracy of locational signals with the result of introducing cross-subsidies between different network users.
- (31) This observation is reinforced by the comparison of the following two ratios: i) domestic revenue over cross-border revenue on the one hand, and ii) domestic

¹⁵ See section 3.3.1.1. of the Framework Guidelines on rules regarding harmonised transmission tariff structures for gas, [FG-2013-G-01](#), 29 November 2013.

¹⁶ See section 3.3.1.4. of the Framework Guidelines on rules regarding harmonised transmission tariff structures for gas, [FG-2013-G-01](#), 29 November 2013.

commercial capacity over cross-border commercial capacity on the other hand. The first ratio equals 1.46 while the second ratio equals 1.97. This implies that a unit capacity volume is sold at a significantly lower price for a domestic use than for a cross-border use.

- (32) Article 13(1), subparagraph one, of Regulation (EC) No 715/2009 establishes that tariffs “*shall... reflect the actual costs incurred, insofar as such costs correspond to those of an efficient and structurally comparable network operator and are transparent, whilst including an appropriate return on investments, and, where appropriate, taking account of the benchmarking of tariffs by the regulatory authorities*”. . In addition, Article 13(1), subparagraph three, of Regulation (EC) No 715/2009 establishes that tariffs “*shall facilitate efficient gas trade and competition, while at the same time avoiding cross-subsidies between network users.*”, This also means that by including avoidable associated cross-subsidies into the cost allocation methodology the objectives of Article 13(1) of Regulation (EC) No 715/2009 identified above will not be achieved.
- (33) As established in the FG, to determine tariffs in compliance with Article 13 of Regulation (EC) No 715/2009, the NRA shall define a cost allocation methodology. Transmission system characteristics used as inputs shall be adapted to the cost allocation methodology. Among the other transmission system characteristics: “the network representation used as an input to the methodology, clarifying whether this is detailed or simplified, consistent with the chosen allocation methodology that, when appropriate, shall include segments and allow an evaluation of potential cost drivers from entry points to exit points, including distances, pipeline sizes, and any others that are deemed relevant by the concerned TSOs, or NRAs, if they deem it appropriate”¹⁷. As a consequence, the choice of a network representation and its level of detail should be consistent with the chosen cost allocation methodology. However, as underlined above at 0, the simplified network, as defined by the Decision, is inconsistent with the choice of the matrix methodology since it lacks the necessary accuracy of the initial representation of costs.
- (34) Moreover, as regards the criteria for the choice of a cost allocation methodology, “the choice for or against the matrix methodology, or the virtual point methodology, relative to the capacity weighted distance methodologies, shall consider both the drawback of necessary network representation simplifications and the benefit in cost reflectivity, as compared to the capacity-weighted distance approach”¹⁸. In this respect it appears that, in the Decision, the NCC did not assess the drawback of the chosen simplified network against the benefit in terms of cost reflectivity gained from the choice of the matrix methodology.
- (35) Finally, as explained above at 0, according to the Decision, ‘indirect’ costs corresponding to the secondary network connecting the primary network to domestic consumers are allocated to system users on the basis of locational signals established on

¹⁷ See chapter 2.3 of the Framework Guidelines on rules regarding harmonised transmission tariff structures for gas, [FG-2013-G-01](#), 29 November 2013.

¹⁸ See section 3.2.1.1. of the Framework Guidelines on rules regarding harmonised transmission tariff structures for gas, [FG-2013-G-01](#), 29 November 2013.

the basis of ‘direct’ costs corresponding to the primary network. In this regard, it is noted that Article 2(1), point (3), of Directive 2009/73/EC defines the term “transmission” as *“the transport of natural gas through a network, which mainly contains high-pressure pipelines, other than an upstream pipeline network and other than the part of high-pressure pipelines primarily used in the context of local distribution of natural gas, with a view to its delivery to customers, but not including supply”*. In addition, Article 2(1), point (5), of the above Directive defines “distribution” as *“the transport of natural gas through local or regional pipeline networks with a view to its delivery to customers, but not including supply”*.

- (36) In its justification of the scope of the direct costs, the Decision does not show that the costs related to the operation of the distribution network are not identifiable and hence have to be treated as indirect costs. Rather, the Agency notes that an approach was followed preferring the use of a simplified network which employs locational signals for the transmission network, but excludes the costs linked to the operation of the distribution network from the scope of the direct costs. The argument that the part of the transmission network shared by domestic and cross-border users (the primary network) and the part of the transmission network dedicated to domestic use (the secondary network) have the same technical and ownership characteristics is not sufficient to justify the simplified cost approach as taken in the Decision. The two networks are inherently different, -and are accordingly also differently defined in the Directive,
- (37) From the above it follows that the costs related to the operation of the part of the transmission network dedicated to domestic use should feature as an essential element in the matrix methodology, to the extent that cost data can be directly related to this network.
- (38) The Agency notes that efficient locational signals should result in system users contributing to the costs of these services proportionately to their use of these services to the extent permitted by the chosen cost allocation methodology.
- (39) In order to solve this misalignment, NCC should define the cost allocation methodology on the basis of an assessment of cost reflectivity, stability, and the potential trade-offs between those. Subsequently, the necessary input to the cost allocation methodology can be determined. In case the assessment supports the employment of a matrix methodology, the input of the network representation should be improved by including the transmission costs caused by domestic users to the extent that they belong to the transmission network within the meaning of Article 2(1), point (3), of Directive 2009/73/EC and adequately detailed. If this is not the case and the NCC prefers to give more weight to equalisation, it should consider the employment of other methodologies, such as postage stamp.
- (40) Following the application of the adjusted cost allocation methodology, the Agency recommends that NCC evaluates the extent of cross-subsidies between domestic and transmission users, resulting from the application of the methodology, at the level of the Entry-Exit zone. The FG provide guidance on how to conduct such a cost allocation

test¹⁹. The Agency recommends that such a higher level constraint – the passing of the cost allocation test – be respected.

HEREBY DELIVERS THE FOLLOWING REASONED OPINION

Article 1

Decision No. O3-839 of 13 October 2014 of NCC on the amendment of the Methodology for the Determination of National Regulated Prices in Natural Gas Sector does not comply with Directive 2009/73/EC and Regulation (EC) No 715/2009, and in particular with Article 13 (1) thereof, as:

- i) There is a misalignment between the chosen methodology and the associated input, in so far as the expected high level of cost-reflectivity resulting from the matrix cost allocation methodology is hampered by the use of a highly simplified network representation. As a result, 70% of the allowed revenue is allocated on the basis of the locational signals provided by 30% of the allowed revenue;
- ii) There is a misalignment of the methodology in so far as the latter results in cross-border users bearing transmission costs caused by domestic users, which constitutes a cross-subsidy between network users within the meaning of Article 13 (1) of Regulation (EC) No 715/2009.

Article 2

Pursuant to Article 7(5) of Regulation (EC) 713/2009, the Agency invites Valstybinė Kainų Ir Energetikos Kontrolės Komisija, to whom this Reasoned Opinion is addressed, to take the necessary measures to comply with this Reasoned Opinion and to report on the measures that have been adopted within four months of its receipt.

Done at Ljubljana on 18 June 2015.


Alberto Pototschnig
Director

¹⁹ See section 3.2.2 of the Framework Guidelines.



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