

Virtual Gas Pipeline: New Challenges in the Gas Regulatory Framework

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Abstract

The virtual gas pipeline (VGP) is a technological innovation which has been developed so as to supply gas in places that the physical gas distribution system is unable to reach. The VGP activity is usually a competitive (i.e. commercially speaking) activity and, as such, it is carried out and is dependent on market conditions. This article discusses the question of whether a gas operator is entitled to develop a local gas network, in cases where this is not yet connected to the distribution system, and as such this local network would be served by a VGP. It also discusses the terms, conditions and presuppositions based on which the above activity—especially in CNG—is to be regulated, i.e. to be carried out by a gas operator,¹ and is also the subject of the supervision of such an operator and whereby the cost of this activity is to be included in the operator's regulated income, so that it is recovered by all customers, regardless of whether they are connected to the distribution system or the local (secondary) network.

What is the VGP?

The VGP is the “network” that substitutes for the physical gas distribution system,² transmitting gas, either via land—by trucks, or via sea by ships. Obviously, the VGP does not have the technical characteristics of a physical network. In fact, the VGP replaces and supplements the physical gas network, where the expansion of the latter is not, at least temporarily, economically efficient. Accordingly, the VGP “copies” the physical network and secures the permanent flow of gas with the use of trucks and/or ships to off-grid (isolated) places, where the final customers are not served by the physical distribution system. Actually, what it constitutes is a

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¹ A transmission system operator (TSO) means a natural or legal person who carries out the function of transmission and is responsible for operating, ensuring the maintenance of, and, if necessary, developing the transmission system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the transport of gas (Gas Directive art.2(4)). A distribution system operator (DSO) means a natural or legal person who carries out the function of distribution and is responsible for operating, ensuring the maintenance of, and, if necessary, developing the distribution system in a given area and, where applicable, its interconnections with other systems, and for ensuring the long-term ability of the system to meet reasonable demands for the distribution of gas (Gas Directive art.2(6)).

² Distribution means the transport of natural gas through local or regional pipeline networks, which mainly contains medium and low-pressure pipeline, with a view to its delivery to customers, but not including supply (Gas Directive art.2(5)). The distribution system is considered a “natural monopoly”.

form of gas flow, in the form of either SNG or LNG,³ through a network with another physiognomy, different from that of the physical pipeline. As such, it seems that a new regulatory framework should be established, or integration into an existing one should be performed, owing to the similarities of the VGP to the physical network, and also owing to its capability for proportional application.

The purpose of VGP

The purpose of VGP is the same as the purpose of the physical gas pipeline, i.e. the transportation of natural gas to the delivery points and, in particular, the transportation of gas from the exit points⁴ to the final customer, resulting in a sufficient penetration and use of natural gas. In addition, the VGP supports the competent operator and any customer as an emergency factor (security of supply), in case the flow of gas is interrupted by various reasons. It is needless to point out the usefulness of natural gas as an alternative fuel to oil, not only because it contributes to the protection of the environment, but also owing to the economic efficiency and gross calorific value that it bears. The use of natural gas, as the most economically efficient energy source, contributes to the development of the competitiveness of SMEs and the large energy consumer enterprises. Gas consumption penetration constitutes a firm target of the European Union (EU) and the European Economic Area (EEA) states. In particular, the *Energy Roadmap 2050*⁵ refers to gas as a significant key to the transition to a low-carbon emissions era. In addition, the European Commission considers gas as highly critical for the transformation of the energy system and as a decisive factor for the reduction of the greenhouse emissions, via the use of existing technologies, at least until 2030 or 2050.

The use of VGP

The VGP is used for the transportation of natural gas in areas where the physical gas network is not able, for various reasons, to reach the final customer who desires to use this alternative energy source. As the construction of the distribution system (physical gas network) demands economic viability and effectiveness, namely the existence of a significant number of final customers and respectively substantial gas supply in the specific geographical areas, if the above presuppositions are not fulfilled, the VGP is able to cover this necessity for a transitional period in a specific area, until the final expansion of the physical gas network, or in order to fulfil emergency needs at any time. It could therefore be argued that the VGP is the alternative to a physical gas pipeline. In other words, the VGP substitutes the physical gas network in cases where the expansion of the latter, at least at a non-mature stage, would disproportionately burden the tariff of the network, owing to the low flow, if compared with the cost of the investment for the physical connection of isolated areas. In other words, the operation of the VGP serves the economic efficiency of the network, along with the avoidance of a high economic

³ Where this article refers to gas at VGP level, it should be considered to refer to the activities of compression, decompression, gasification, regasification and transport of CNG or LNG.

⁴ "Exit point" refers to the point where gas leaves or is deemed to leave the national grid.

⁵ Commission, *Energy Roadmap 2050* (2012), p.12.

burden for the consumer. It is also the only supply solution in places where the geomorphology of the area does not allow any physical connection.

The forms of VGP

To begin with, as already stated, the VGP covers the necessities of off-grid final customers. Depending on the way that the gas flows and the purpose which is to be served, the VGP is divided into two categories: The distinction is important in order for the respective activity to be considered as a regulated one or a competitive (commercial) one.

The first category concerns the activity of natural gas, in order for it to be delivered to the off-grid final customer. In this case, the necessary equipment is owned by the customer. At a regulatory level, a tariff (and the methodology thereof), approved by the Regulator, is required at the exit point. For example, in case of CNG, it is first loaded from the compression point in cylinders, and then trucks transport them (the cylinders) to the de-compressor, which is located in the installation of the off-grid final customer. This situation constitutes an activity directly exposed to the competition and it is not the case herein.

The second category refers to the entry points⁶ from which the natural gas enters the distribution system from a CNG or LNG installation, after which a secondary (local) gas network is deployed for the supply of one or more off-grid final customers. In this case, the natural gas is loaded in cylinders, which are first loaded in trucks and thereafter transported to the delivery point: that is to say, the CNG decompressor or the LNG re-gasificator which is owned by the distribution operator, so as to supply the secondary (local) gas network. The latter is constructed at a local level for the transitional supply of CNG or LNG to off-grid final customers until the expansion of the physical gas network. At the end, the secondary (local) gas network will be connected to the main gas distribution system when possible. In light of the above, the VGP plays the role of the pipeline which connects the distribution system to the secondary (local) network and then to the off-grid final customer.⁷

In this article we examine and discuss the second category/case so as to determine whether the specific activity (compression and/or gasification and transport), although a competitive one, can be considered as a regulated activity and as such to be carried out by the competent gas system operator under specific conditions.

The activity of VGP with regard to the EU legislation

The gas markets within the territory of EU are ruled by Directive 2009/73 (Gas Directive).⁸ The Directive belongs to the so called Third European Energy Liberalization Package.⁹ The Gas Directive has positively changed the way of

⁶“Entry point” refers to the point where gas enters or is deemed to enter the national grid.

⁷The local gas network is an off-grid gas network not yet physically connected to the distribution system.

⁸Directive 2009/73 concerning common rules for the internal market in natural gas and repealing Directive 2003/55 [2009] OJL211/94. The Directive establishes common rules for the transmission, distribution, supply and storage of natural gas. It lays down the rules relating to the organisation and functioning of the natural gas sector, access to the market, the criteria and procedures applicable to the granting of authorisations for transmission, distribution, supply and storage of natural gas and the operation of systems (Gas Directive art.1).

⁹The Third European Energy Liberalization Package includes the Directives 2009/72 (Electricity Directive), 2009/73 (Gas Directive) and the Regulations 713/2009 (ACER Regulation), 714/2009 (Electricity Regulation),

exercise of gas activities in the EU and in the European Economic Area (EEA).¹⁰ Today, the energy markets of the EU Member States and the EEA members operate in accordance with the rules of the above Liberalization Package.¹¹ Although there is space for some issues which need to be improved, it is nevertheless incontestable that the implementation of the Directive has significantly contributed to the integration of the gas market in the last 10 years. Thus, the effective separation of networks from the activities of production and trading, known as unbundling, has resulted in: (1) the non-discriminatory access to the networks; (2) the improvement of the competition contributed in the security of energy supply; and (3) the fulfilment of the demand. As a result of all of the above, alongside the implementation of the principle of eligibility,¹² the consumer enjoys better prices and a higher quality of services.

To ascertain the issue of whether the case in question can be carried out on a regulatory basis and for how long, some factors that compose the entire activity should be examined. First of all, the purpose of this activity should be considered. In relation to the purpose of the activity, the first issue to be examined is whether the activity of VGP is allowed by the legislation of the EU.¹³ It is true that in art.2(5) of the Gas Directive it is stated that “distribution means the transport of natural gas through local or regional pipeline networks with a view to its delivery to customers, but not including supply”. Thus, one can say that the activity of distribution is solely linked to a physical pipeline. To address this issue, we should examine the above definition, considering the purpose of the gas distribution system (as fulfilled through the operator). In this regard, the task of a DSO is

“to ensure the long-term ability of the system to meet reasonable demands for the distribution of gas, and for operating, maintaining and developing under economic conditions a secure, reliable and efficient system in its area, with due regard for the environment and energy efficiency”.¹⁴

From the point of the interpretation of the EU legislation, the following conclusions can be drawn: (1) the European law-maker does not exclude the distribution operator from the construction of local (secondary) gas networks that are not connected to the main distribution network; (2) the European law-maker does not prohibit the activity of VGP, while specifically excluding the activity of supply; and (3) the European law-maker aims at the establishment of an entire regulatory framework able to correspond to a long-term ability of the distribution system, so as to meet the reasonable demands of the customers. Obviously, this framework initially refers to the physical gas distribution system, but this does not mean that the reasonable demands cannot be satisfied by another network, in cases where the physical network would be unable to meet such a demand. This is due to the

715/2009 (Gas Regulation). The above “package” constitutes the third-generation Union legislation on the Energy Markets Liberalization.

¹⁰ The functioning of the network operators, the certification of the companies deriving from third countries, and the access to the storage facilities are some of the innovations of the Gas Directive.

¹¹ Neighbouring countries of the EU usually implement this legislation in order to exercise the Cross-Border Energy Trade.

¹² The right of the customer to switch, that is to say the ability to change his supplier after the expiration of the supply contract or even before. From 1 July 2007 all energy customers in EU have been eligible, unless the Member State is granted a derogation as per art.36 of the Gas Directive.

¹³ If that state is not a Member State, the national legislation should be examined.

¹⁴ Gas Directive art.25(1).

fact that the main will and intention of the European law-maker (and that of the European Commission) is the higher penetration of natural gas under the conditions of economic efficiency and the security of continuous supply. In this sense, the phrase “reasonable demands” can be interpreted so as to mean that the distribution operator can meet the demands of the consumers who are also located in off-grid areas and want to be supplied with natural gas. Such “reasonable demands” of the customers could be satisfied with the VGP, and in this way fulfil the policy of the European Union and of the Member States for the further penetration of natural gas.

At this point, it should be clarified that the definition of “distribution” in the Gas Directive refers to the physical gas network solely; however, it should not be an obstacle so as to impede the VGP being also the subject of the distribution system operator, as the diffusion of some types of gas distribution (i.e. CNG), at the time of the issuance of the Gas Directive was not high and hence was probably unknown.

Thus, the above-mentioned interpretation of the terminology of both the terms “distribution” and “reasonable demands” in the Gas Directive highlights the fact of the temporary inability of the physical gas network to meet the reasonable demands of the consumers, which is to be replaced by the VGP. This, not only constitutes a continuity of the physical gas in the frame of the willingness and aim of the distribution system operator to endeavour its best efforts to achieve the maximum gas penetration, but it also contributes decisively to the protection of the consumer and of the environment, as well as to the achievement of energy efficiency, and, hence, overall to the fulfilment of the so called Social Regulation¹⁵ and the aims of the EU.

Considering the issues examined above, it is safe to conclude that, on one hand, the activity in question has the characteristics of a regulated activity and, on the other hand, it can fall within the regular tasks of a distribution system operator.

The legal nature of the particular acts in CNG

The operation of the VGP in CNG consists of a series of acts (phases). It is actually a complex procedure. First, the natural gas should be compressed. Next, the compressed natural gas is transported by trucks to the decompressor, and finally the CNG is decompressed and transported to the final customer through the secondary gas network.

It should be noted that the delivery point may be located either within or beyond the physical limits and geographical scope of the gas distribution network. For the purposes of the present analysis, the delivery point is considered to be beyond the physical gas network. It should be clear that the operation of VGP, as is examined in this article, presupposes the existence of a secondary (local) physical gas network, so that it can be considered as a secondary service.

The categorisation of an activity as regulated or competitive cannot be absolute, especially in cases where the relative market is not mature, or in cases where it is in the early stages of its liberalisation. In this case, a gradual adjustment is

¹⁵ “Social Regulation”, in contrast to Economic Regulation, targeting the wide benefit of the consumer, and the protection of the environment; in other words the Social Regulation is the regulation that brings surplus benefit to society.

required.¹⁶ Another aspect involves the fact that such activity needs to be regulated for reasons of public interest and public policy. Bearing in mind the condition of the ad hoc examination of every single case, and considering also the particular characteristics of the relevant market, the initiative of the categorisation of the activity as competitive or regulated belongs to the law-maker. However, the contribution of the Regulator in this issue is similarly decisive and as such classified as a “*conditio sine qua non*”.

The distribution operators may decide to extend their own activities to other activities (e.g. diversification and scope effects) so as to strengthen the demand, hence resulting in the construction of a physical gas network (the so-called scale effects). Such an extension of activities could offer benefits for the development of the infrastructure, and thus the growth of competition. In this regard, no barriers should be imposed in order for the consumers as well as other market participants to enjoy the maximum benefits of such services. The operators are the entities most competent to carry out such activities owing to their experience and knowledge of how to operate the networks. In parallel, no interactions between the regulated and the competitive activities should occur. In the case involved in our discussion, the suppliers will continue to carry out their regular competitive activities, thus supplying the off-grid final customers. Thus, in the case where the operator develops a VGP, the following secondary activities should be undertaken: (1) the operator compresses the natural gas with a compressor already installed in the existing physical gas network and store it in cylinders; (2) the operator transports the cylinders with a special truck in the decompressor (arrays), installed in the local (secondary) network; and (3) the operator decompresses the CNG and injects it into the local gas network in order for the gas to be delivered to the delivery points of this network (off-line final customers). The above-mentioned activities should be undertaken by the operator via assignment to third parties to be designated and awarded with the task via the procedure of a public tender. In this way the assignment of the activity is guaranteed to take place with transparency and as per the observation of objective criteria. It is also highly recommended that such assignments should be made through tender procedures so that competition among the potential contractors can take place.

In addition, in many cases the intervention of the operator, although temporary,¹⁷ aims at the mitigation of the monopoly or oligopoly impact, which some companies attempt to exercise in a primitive market. It is obvious that the transport activity belongs to the competitive activities, if it is to be considered as ad hoc. However, in our case, the transportation of the CNG cylinders from the compressor to the decompressor—if we also consider the fact that it happens under the condition that it takes place so as to supply the secondary (local) gas network (off-grid network) which is not connected to the physical gas distribution network—loses

¹⁶ Within the frame of market under the primitive phase of liberalisation, it is not unusual for a competitive activity to be subject to regulation. A characteristic example is the regulated price of the natural gas, when a derogation according to art.36 of the Gas Directive is granted, or the compensation of RES producer through a guaranteed FiT. In the past, several competitive activities were subject to regulation in other sectors such as the requirement of getting feasibility license for carrying out the domestic shipping for the barren lines for reasons of public interest (*cabotage*).

¹⁷ According to Delong and Summers, instead of state intervention, the temporary monopoly power of the natural monopolies and the corresponding profits are the necessary reward required to push private initiative to deal with innovations: see J. Bradford Delong and L. Summers, “The ‘New Economy’: Background, Historical Perspective, Questions and Speculations”, https://www.researchgate.net/publication/5043970_The_'new_economy'_background_historical_perspective_questions_and_speculations [Accessed 2 January 2020].

its competitive character because it becomes a part of the complex VGP activity. In other words, this sort of transportation serves the supply of the secondary gas network, which is under the operation and supervision of the distribution system operator, and is not directly linked to the competitive activity of supply; hence, the social and economic purpose of the VGP could not be fulfilled without this kind of transportation.

Furthermore, it should be noted that a likely consideration of this secondary activity, as noted above, is a purely competitive one, and as such it could cause problems to the penetration of natural gas, owing to the fact that the owners of the compression and decompression stations and the transporters could unilaterally ask a high price for their service. This abusive behaviour could impose a barrier to the economic efficiency of the VGP, resulting in the reluctance of the final customers to accept price discrimination between the customers who are connected to the physical gas network and the customers who are to be connected to the VGP. In this regard, the above-mentioned activity at the regulated base contributes to the avoidance of abusive behaviours on behalf of private individuals who have the availability or the means to exercise the relevant activity. In other words, at the early stage of the liberalisation of the relevant market, a small number of entities with the necessary investments could manipulate the relevant market, forming oligopolistic conditions and, thus, distorting the competition.¹⁸

The view that the entire operation of the VGP is under regulation (including the part played by transportation) until the expansion of the physical gas network or the full operation of competition is not contrary to the notion and the scope of the EU legislation, first because, within the frame of the liberalisation, the gradual adjustment of the relevant market is very common, and secondly because the purpose of public interest is served.

In addition, the inclusion of CNG quantities transport costs in the regulated revenue of the competent network operator will prevent the unequal treatment of the natural gas customers—i.e. the customers who are connected to the physical network as well as the customers who are not connected—with the same energy profile, while both are willing to use the natural gas for their own needs. The cost of the entire activity within the frame of VGP should be included in the operator's regulated income as well. It must be noted that the above does not exclude the possibility of a compressor under third person ownership.

The purpose of public interest and public policy

The concept of public interest is vague and defined by the rule of law. Public interest is of a social nature. Energy activities by nature serve the public interest because of the great social importance of energy and its high contribution to the national economy of the states. Especially in the energy sector, the public interest varies. First of all, it serves to achieve a fully functional, competitive and efficient single energy market for the benefit of the consumer. In this sense, high-quality services at a reasonable price should be provided. Last but not least, the existence

¹⁸ For this reason, it is suggested that the regulated tariff of the relevant service should be formed by the Regulator with a cap, so that the interested parties will be invited in a call for tender offering a price lower than the roof price, in order a better competition in favour of the consumer to be achieved.

of healthy competition and security of supply are important elements of public interest.

The entire VGP activity, as described above, serves the purpose of public interest. To begin with, the final customers who are unable to connect to the physical network will enjoy an energy source with economic efficiency and gross caloric value for their own professional and industrial use, and at the same time they will contribute to the increase of the enterprise competitiveness with positive results in the national economy. It should be noted that the latter constitutes an essential target of the EU legislation.¹⁹ Subsequently, the use of natural gas contributes a great deal to the protection of the environment, and in this way it is relieving the latter of greenhouse emissions, as well as supporting the effort of the EU to achieve its international environmental obligations.

Third-party access (TPA)

The rule of TPA to the networks is based on the legislation of the EU and is one of the main pillars of the European Liberalized Energy Market.²⁰ However, the interpretation of TPA is provided by the European Court of Justice (ECJ) case law.²¹ In this sense, every supplier of natural gas is entitled to have access to the gas market and network, representing their customers, whether the customer is connected to the transmission/distribution system or lies beyond the system. Thus, if the VGP is adopted as a regulated activity (compression and transport), the competent operator should grant any third person with an established legitimate interest access to the network, the VGP included. As a result, the supplier or/and the final customer is entitled to ask for access to the compressors and decompressors, as well as to the use of the means that will be employed for CNG transport within the frame of VGP. This activity could be carried on by transporters who have the necessary means fulfilling the technical and safety requirements.

The relationship between the VGP and the gas supply

As per the EU legislation, since no specific restriction exists, the activity of supply can be carried out for customers who are connected to the network or beyond it (off-grid customers). The operation of the VGP should not be confused with the activity of supply. The latter continues to be carried out under fully competitive (commercial) terms. In addition, competition will increase owing to the fact that more customers will use natural gas, and a higher penetration of gas will be achieved. In this sense, the final customers, whether they are isolated customers or connected to the secondary network, are eligible, that is to say, free to choose their own supplier or to change the current one. For off-grid customers, the CNG or LNG supply refers to the supply to the (customer's) delivery point.

¹⁹ See Preamble of Gas Directive, Recital 1.

²⁰ See Gas Directive arts 32–35.

²¹ See mainly *Oberlandesgericht Dresden* (C-439/2006); *Sabatauskas* (C-239/2007).

Does the activity of VGP fall within the status of a state aid regime?

This issue needs a thorough analysis, which goes beyond the scope of this article. Some aspects, however, can be examined. It is likely (but rare) that this activity could fall into the state aid regime.²² However, considering the relevant provisions of the EU legislation,²³ we can safely conclude the following: as mentioned above, the VGP is not an autonomous activity; rather, it is complementary to the distribution chain. As the distribution operator is entitled to construct a local (off-grid) physical gas network, it needs the means to fulfil the obligations to supply customers with gas. In this regard, the possibility of a VGP operation would not be considered a new exclusive right conferred to the operator, but a right linked to the main task of the distribution operator to expand the network.²⁴ Among the competencies of a DSO, the expansion of the network is a significant task.²⁵ Furthermore, it should be examined whether the establishment of VGP facilitates the development of certain activities or certain economic areas.²⁶ As per our discussion and analysis, it is obvious that the VGP facilitates the process of gas supply, since the penetration of gas in a specific area multiplies the sales of the suppliers and the competition among them in favour of the consumer. Furthermore, it is highly certain that the VGP develops the economy in areas where the physical network is not able to reach them, because it helps the economic efficiency of the SMEs and/or the large energy consumers. However, the question arises as to whether the VGP adversely affects the trading conditions to an extent contrary to the common interest. In light of the above, the VGP cannot be considered as having a negative impact on the supply process. On the contrary, it should be concluded that it helps the expansion of this activity. Finally, the VGP (if regulated) prevents the exercise of manipulative behaviours during the non-mature period, i.e. it prevents a potential abusive behaviour of transport or compressor owners which would allow them to charge higher costs for their services. In other words, the compatibility of VGP activity as referred to in this article could be based on the SGEI framework,²⁷ and it could therefore be considered as compatible to the internal market.

²²In particular, to be considered Services of General Economic Interest (SGEI). However, every single case should be examined ad hoc.

²³As per art.106 TFEU: "1. In the case of public undertakings and undertakings to which Member States grant special or exclusive rights, Member States shall neither enact nor maintain in force any measure contrary to the rules contained in the Treaties, in particular to those rules provided for in art.18 and arts 101 to 109. 2. Undertakings entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly shall be subject to the rules contained in the Treaties, in particular to the rules on competition, in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them. The development of trade must not be affected to such an extent as would be contrary to the interests of the Union." As per art.107 TFEU: "1. Save as otherwise provided in the Treaties, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the internal market. ... c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest."

²⁴Gas Directive art.25.

²⁵TFEU art.106.

²⁶TFEU art.107(3)(c).

²⁷See the European Union Framework for State Aid in form of public service compensation (2012/C 8/03) and in particular para.56.

Conclusions

A competent distribution gas operator is entitled to develop a local physical gas network, even if it is not yet connected to the distribution network, and to serve it with a VGP as to meet the gas demands of off-grid customers. The infrastructure needed will be conducted under the auspices of the operator, and as such the VGP will need to be assimilated to the physical gas network until the local (secondary) network is connected to the physical network.

In cases where the compressor or the gasificator, as well as the transport of the VGP activity is carried out by the operator, the cost thereof will be included in the income of the operator and will be reimbursed by all consumers, whether the consumers are physically connected or not.

Both physical or virtual infrastructures of VGP are subject to TPA against a tariff previously approved by the Regulator.

Any (de)-compression or (re)-gasification services and any transportation involved could be offered by third parties through an open tender, the process of which is for the operator to publicise and conduct, in an effort and with the aim to achieve the lowest possible cost on behalf of the awarded entity, with the parallel observance of objective and transparent criteria.