



**EFET Comments on
CEER Blueprint on Incremental Capacity**

The European Federation of Energy Traders (EFET)¹ welcomes the Blueprint on Incremental Capacity developed by the Council of European Energy Regulators (CEER). In our view, market-based investment mechanisms are superior to planned approaches, as they reflect what the market is willing to book and pay.

We see open seasons and integrated auctions as two complementary market-based approaches. Open seasons are better suited to large complex projects, which may cross more than one market zone or bring new gas supply to Europe, while integrated auctions are more efficient for marginal investment on single interconnection points. The former enable proper coordination between several Transmission System Operators (TSOs) and National Regulatory Authorities (NRAs), and allow projects to be optimally sized and routed and can cater for larger risk of both shippers and TSOs to be mitigated and managed; the latter are easier to standardise and combine with the long-term capacity allocation auction process, and provide more opportunities for new entrants to buy capacity, as such auctions can be held regularly, i.e. every year as part of the capacity allocation process defined in the EU Capacity Allocation Mechanisms Network Code.

With a view to bringing the discussion on incremental capacity forward, in the sections below we offer some comments and elaborate on a few outstanding concerns related to the suggested approach. We welcome ACER continuing the work started by CEER and would ask for further workshops to help develop the concepts.

Section 2.3. Key principles for market driven investment processes.

One of the key principles, which should be embedded in a market-driven investment process for incremental capacity is that *shippers should know in advance what level of commitment in terms of price, capacity booking and booking duration is required for the TSOs to be obliged to provide the incremental capacity.*

In relation to bundling, the section assumes that new capacity will be offered on a hub-to-hub basis. Consideration needs to be given in terms of costs-revenues split to how to deal with a new pipeline creating additional capacity in the “upstream” entry exit zone, which then matches with available existing capacity in the “downstream” entry exit zone, such that new capacity is not needed in the “downstream” entry exit zone.

Section 3. When to offer incremental capacity.

¹ The European Federation of Energy Traders (EFET) promotes and facilitates European energy trading in open, transparent and liquid wholesale markets, unhindered by national borders or other undue obstacles. EFET currently represents more than 100 energy trading companies, active in over 27 European countries. For more information: www.efet.org.

A key consideration is that shippers must have the confidence to know that they can trigger an incremental capacity process, even if new capacity is not included in the Ten Year Network Development Plans, and there is no indication of a congestion premium in the long-term capacity auctions.

Therefore we propose that the following should be a potential means for Open Seasons to be initiated as, unlike the integrated auction approach, it is less clear how Open Seasons can be triggered.

- Plans by TSOs to offer incremental capacity e.g. as part of network development plans.
- Proposals by project developers for incremental capacity e.g. large new infrastructure projects connecting markets to new or additional sources of supply. Such project developers could be existing TSOs or potential new TSOs.
- Requests by shippers to TSOs for incremental capacity processes to be triggered e.g. producers wishing to connect new or additional sources of supply to the market.

To enable the above, NRAs will need to give consideration to how to certify new TSOs so that the process does not discourage investment by project developers. TSOs and NRAs will need to consider how to respond to requests by shippers for new capacity, for example, how to finance any preliminary design work prior to the Open Season process.

Section 4. How to offer incremental capacity.

The Blueprint does not comment on procedures for “simple” incremental capacity where an adjustment to the existing CAM methodology is proposed.

For the purposes of this paper, we assume that such an amended CAM procedure will not be sufficient for projects which cross more than one border between adjacent entry and exit zones and therefore, require coordination between more than two NRAs and two TSOs, or for new upstream projects connecting with downstream markets. We, therefore, agree with the Blueprint that an Open Season type process is more suited to such cases. (Footnote 14, page 13. CEER Blueprint on Incremental Capacity.)

Section 4.1 Offer of capacity increments together with existing capacity in the CAM Network Code long term allocation; investment decision based on user commitments obtained in allocation

The ascending clock mechanism, which has been adopted for CAM, presents certain difficulties. In relation to Technical Design 1, it is important to note that price steps do not reflect the costs of providing capacity. They are only means to determine the allocation of capacity. Thus, the economic test is decoupled from capacity allocation. Also it is difficult to see when the economic

test is met, as the auction results would have to be put into a different spreadsheet. Shippers need to have the model of the economic test, so that they can modify bids if required to ensure that the test is passed.

Technical Design 2 is in our view, more effective even though the use of parallel bidding ladders appears more complex. If for each bid ladder the P0 price is set at the average weighted regulated costs of providing the existing and incremental capacity, the problem of decoupling auction price steps from the regulated cost of providing capacity could be resolved.

Section 4.2. Open Season procedures.

Technical Design 1. Open Seasons with pre commitments and ex post use of the CAM algorithm.

We do not agree with this proposal because the use of CAM ex post means that shippers face the risk that, having helped trigger the Open Season process, they would not be allocated capacity in a CAM style auction. This would undermine the objective of having an Open Season in the first place.

It should be possible to design a process that is sufficiently iterative to enable a project to match proposed supply of capacity to demand for such capacity from shippers, such that the use of an auction procedure is not necessary. An important difference between an Open Season process and a CAM style process is that the initial design phase of the project can tailor the project to market demand. This should ensure, for example, that the configuration of the project in terms of different capacity sizes per leg of the project can be tailor-made.

The use of CAM ex post also implies that shippers may pay more than the regulated cost for capacity. This raises questions of potential revenue over recovery by TSOs, or cross subsidization between groups of shippers.

Technical Design 2. Open Seasons with pro rata.

Whilst this approach is flexible, as recognized by the CEER Blueprint itself, there are issues concerning the use of pro rata and the way the economic test is applied.

However it is not clear what is meant by the statement that the benefits of CAM may be undermined, as it is not specified which CAM benefits could be undermined or how. The main benefit of CAM is that it creates an open and transparent process, which allows for non-discriminatory allocation of existing capacity.

A well-designed iterative process for the Open Season should ensure that the project is appropriately sized to meet shippers' demand for capacity. This should avoid the need for pro rata. Furthermore, by definition an Open Season is open to all shippers who meet the criteria for

participating in such a process. So long as the criteria are fair and relevant, there should not be any problems with undue discrimination.

The proposal takes too much of a “mechanistic” approach in the way that the economic test is applied, for example, by talking about “development steps” and “bidding windows”. In practice, close cooperation between shippers and the project developer will be required so that both parties have a clear understanding of their respective requirements. This should mean that a project can be as optimally sized as possible before shippers are required to make binding commitments; once shippers have made such binding commitments, the project developer can apply the economic test to see if the project can go ahead.

The use of existing unallocated capacity to provide capacity as part of a new project should not be considered an argument against the use of such an approach. Firstly, it is highly likely that such capacity may be used in a project which crosses multiple entry/exit zones and it is therefore, more efficient to utilise “unused” capacity, rather than to build additional capacity, which could become a stranded asset.

The CEER paper correctly identifies the need for clear guidance on the withdrawal of capacity from the CAM auctions for use in an open season process. If correctly applied, there is no reason why the principles of CAM cannot be respected in the Open Season process, namely an open and transparent process which allows for the non discriminatory allocation of capacity.

If a project developer intended to use existing unused capacity to support an Open Season process the following approach could be taken:

- Prior to the next long term CAM auction, the project developer could announce that unused capacity at a certain IP would be used as part of a forthcoming Open Season process. As the capacity would be for years in the future which allowed for the construction of new pipelines etc., shippers who wanted to use capacity at that IP would have the choice of either bidding for the capacity in the forthcoming CAM auction, or securing it in the forthcoming Open Season process. Capacity for the IP which was available before the planned start date for the capacity allocated via the open season would not be affected.
- If the capacity which was scheduled to be withdrawn was bought in the CAM auction, then clearly this would no longer be available for use in the Open Season process. Capacity which had been specified as being required for the Open Season process would not be available in future CAM auctions if it was allocated as part of the Open Season process.
- Capacity which had been withdrawn for use in the Open Season process but was then subsequently not used in the Open Season would be made available in the next CAM

long term auction after the Open Season process had concluded or it was decided that the withdrawn capacity was not needed, whichever was earlier.

Such an approach ensures that shippers are always informed as to the likely future availability of capacity in the long term CAM auction. The decision by the TSO to withdraw capacity for use in an Open Season is no different from the situation where another shipper decides to bid for that capacity except that shippers know they will have the option of buying capacity in the Open Season and therefore do not need to pay a premium to book the capacity. In this regard the risks for shippers (of not securing the capacity they want) are lower than in the standard open season or CAM processes.

Technical Design 3. Open Season with demand curves.

As with aspects of Technical Design 2, this approach seems to take too mechanistic approach to an Open Season process. For there to be predefined price steps there needs to be a predefined project. However, one of the advantages of a well designed Open Season process is that it allows the project design to be adapted according to the likely needs of shippers, prior to any binding bidding process. Technical Design 3 does not, as currently drafted, allow for such optimal sizing and planning of a project. Technical Design 3 would therefore not be sufficiently flexible to allow project developers and shippers to scope and design a project across multiple entry exit zones. Furthermore, it is not clear why shippers would want to pay more for capacity than the regulated price.

For all the options above, the initial design phase of any large new project is crucial since there are likely to be a number of different options for routes and size of capacity. As noted above iteration between shippers and the project developer is the way to ensure that a project can be properly scoped before moving to the stage where shippers have to make financially binding commitments. Further work is required to design such an iterative process in a way which fulfils the objectives of the Third Energy Package.

5. Design Principles of the Economic Test.

We agree that it is sensible to make the Economic test a financial one, based on the Net Present Value of firm bids received from shippers.

However it is worth distinguishing between how the test can be used in the case of CAM style auctions described in section 4.1 of the Blueprint, and Open Seasons as described in Section 4.2 and discussed above.

In the CAM style auctions the projects are easily definable, and therefore it is easy to construct a CAM style mechanistic process with price steps. This is not the case, for the reasons described above, for Open Season where there can be a choice of routes and capacities.

Therefore, for Open Seasons, the Economic Test should be considered as a final stage which determines whether the project goes ahead (i.e. are there sufficient commitments to make the project financially viable), not as a means of deciding the size of the project as in the case for CAM auctions. In an Open Season process iterative non binding discussions between shippers and the project developer would help scope the route and size of a project. Shippers could then take part in a binding bid process. The sum of the binding bids would be subjected to the economic test, and then the project would be able to go ahead with regulatory approval.

It is important that shippers are consulted on the specifics of the economic test, which may differ according to the nature of the Project, as, for example, the lower the f factor the more likely that un-recovered costs may need to be socialized in the future.

6. Cross border coordination issues.

The CEER paper correctly identifies how projects will be driven by the “short side” of the project where there are mismatches on either side of an IP. The paper also correctly identifies the need for close cooperation between the various TSOs and NRAs along the project. The involvement of interested shippers in the scoping phase would help with this coordination as it would ensure that TSOs / project developers and NRAs were focusing on the routes that were of interest to the market.

On the issue of externalities, it is not clear from the paper how these should impact tariffs in general, and tariffs for those shippers who book (and therefore underwrite) the capacity released via an Open Season.

It is correct that incremental or new capacity may create externalities which benefit the wider market, and this may be taken into account when deciding whether a project should go ahead. However, as with all externalities, the question is how to make those who benefit from such externalities pay for them, or to accept socialization of such externalities.

For example new pipeline connections can improve security of supply. This benefits end consumers in the affected markets. However the capacity still needs to be paid for. If shippers book less capacity than required to pass the economic test, this could mean that the externalities are foregone as a result of the economic test not taking into account the externalities. This could be solved by lowering the level at which the economic test is passed, but this will increase the risk of stranded assets if the amount of capacity booked in future is less than expected. This in turn leads to revenue under recovery.

Under current Tariff Harmonization floating capacity tariffs would be used to deal with such an under recovery. However, such an approach penalizes shippers who did not cause the under recovery. Therefore an alternative would be to explicitly charge the assessed monetary value of any externalities directly to end user via exit tariffs. For example if the threshold for the Economic Test without taking account of externalities was €100m, but the value of externalities

was €20m, the commitment required by shippers to meet the economic test threshold could be reduced by €20m to €80m. A charge of €20m could be added to exit charges and hence passed through to consumers to ensure that the risk of stranded assets was not increased, so that the level of commitment remained at €100m (€80m bookings from shippers plus the €20m externalities charge). The €20m would be paid to the project developer as part of its allowed revenue. Such an approach would ensure the viability of new investment and create a framework that would enable shippers to make long term commitments to meet the economic test and underpin the investment.

7. Implications for rules on Transmission Tariff Structures.

7.1 Socialisation of costs.

The CAM requirement that 10% of incremental capacity be held back for short term capacity bookings create a greater risk of stranded assets in the event that such capacity is not sold as expected.

The same risk of stranded assets occurs when the economic test is set below 100% of the NPV of the project i.e. the project is not 100% underwritten by capacity bookings. A variation of this is when externalities are taken into account (see discussion on externalities in Section 6 above). The advantage of setting the economic test at a value below 100% of the value of the project is that it enables investment to go ahead in an environment when shippers are less likely to make long term bookings as a result of market liberalization.

However costs that are not underwritten, either by initial or future bookings, will need to be recovered. Socialisation of costs across all network issues raises a number of issues:

- If the socialization costs are large relative to the existing system, it may be difficult for network users to bear socialization costs. This may be true, for example, where the bulk of the new capacity is used for transit purposes to flow to downstream entry exit zones, so that the size of the new capacity is large compared to demand in the entry exit zone.
- Socialisation will likely be realized at least partly via floating capacity tariffs. This increases uncertainty for those shippers who have made long term commitments in order to trigger the new investment. The risks of floating tariffs makes it less attractive for shippers to make long term commitments as they will not know the price they will be required to pay for the capacity.
- Targeting of the socialized costs on those who benefit. For example those who benefit from added security of supply (e.g. end users in the entry exit zone) should pay for them if this is possible. This minimizes cross subsidies between different network users.

7.2 Issues relating to the determination of the reference price for incremental capacity.

The paper suggests that shippers may need to pay above the reference price (which is the regulated cost of capacity) in order to meet the economic test. This does not make sense when the alternative is for shippers to pay the reference price but book more capacity in order to meet the economic test.

For example:

Shipper A books 10 units of capacity at £2 to meet the economic test of £20 NPV value. Shipper B books 20 units of capacity at £1 (the reference price) which also meets the economic test of £20. Both shippers meet the economic test, but Shipper B has more units of capacity. Given the choice where shippers have to make the same financial commitment of £20 it seems more logical that a shipper would choose to get more capacity for his money. The argument that this might be more than the shipper needs (4th paragraph page 23) ignores the fact that the shipper has the choice of meeting the economic test or not in order to trigger the investment, in this case a financial commitment of £20. Once this decision is made the shipper will want to maximize the benefit he gains from such a commitment which is to maximize the quantity of capacity booked. This need not mean over-sizing the pipeline, but can be achieved by booking capacity over a longer period of time. Note also that if the scoping of the project is done as a separate stage from the when binding bids are submitted, as described in Section 5 above, it is less likely that over-sizing of the pipeline will take place.

Options 1 through 3 on page 24 of the Blueprint all appear to be overly complex ways of dealing with the possibility that the economic test might not be met at the reference price. None of them are ideal as they all have drawbacks when applied to Open Season capacity. The simplest approach required to avoid the complex options described in the CEER Blueprint paper is as follows.

- Stage 1 of an Open Season process involves an iterative market test stage where the project developer uses non binding commitments from shippers to determine the optimum size and route for the project.
- Stage 2 is when the project developer does the necessary engineering design work to work out the cost of such a project. Combined with the regulatory framework (WACC, depreciation period, etc.) this should allow for the calculation of the reference price.
- Stage 3 is when shippers submit binding bids for capacity at the reference price. If the sum of the binding bids is equal or greater to the economic test the project goes ahead. (Shippers should be given the opportunity to amend their bids if the sum of the bids is just short of meeting the test.)

Such an approach will mean that shippers will pay the regulated cost of the capacity only.

Section 7.3 Issues relating to potential undue discrimination between users of existing and incremental capacity.

The paper correctly identifies that the way to avoid shippers paying premia for capacity at IPs where there is subsequent investment in incremental capacity, namely sufficient transparency of information about forthcoming investment plans. The problem can also be avoided by knowing that investment in incremental capacity can be triggered so long as the economic test is met, and that TSOs or project developers have clear procedures to follow if shippers come to them with requests for new capacity.

Section 7.4 Issues relating to the uncertainty about the evolution of the payable price.

Floating capacity tariffs will discourage shippers from making the commitments necessary to meet the economic test. Some form of fixed price with indexing if required should be considered.

EFET Gas Committee

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