



## Incremental capacity:

### Regulated pipeline investment in response to market needs

#### “The fundamental requirement

The main objective for capacity provision is to **ensure that all reasonable demands for primary capacity are met where it is economic and efficient to do so**. This implies that the existing system should be used to its maximum physical capacity and that demands are met with timely additional investment. The provision of any investment must be done in a way that ensures a TSO can earn a reasonable return on assets for a given level of risk.”

#### Key steps for ‘x-border’ capacity<sup>1</sup>

Transmission System Operators (TSOs) should provide sufficient capacity to satisfy all reasonable requests by their customers, the network users. The EU Gas Directive and EU Gas Regulation require TSOs to co-operate on cross-border investment and connections between TSO systems. The European Federation of Energy Traders (EFET)<sup>2</sup> recommends the following key steps for TSOs, market participants and regulators to follow at existing interconnection points:

1. TSOs provide information on the **usage and forecast physical availability** of capacity at all major interconnection points. This should include future aggregate bookings of capacity and forecast usage based on TSOs’ planning scenarios.
2. Where there is a likely need for investment, TSOs jointly assess the **options for capacity expansion** at each interconnector point.
3. National Regulatory Authorities (NRAs) check the options presented by TSOs and **benchmark project costs** to ensure that they are reasonable and efficiently incurred.
4. If necessary, ACER (Agency for Cooperation of Energy Regulators) could assist NRAs with benchmarking and the **resolution of any differences** in opinion.
5. NRAs **establish an ‘investment test’**, in consultation with TSOs and market participants, such that there is an agreed trigger level of market demand that would immediately trigger investment and allocation of a specified level of incremental (new build) capacity. This test should be published prior to the long-term capacity allocation process.

<sup>1</sup> The quotation in the box is from the [EFET paper on Primary Capacity Allocation](#), published in September 2008.

<sup>2</sup> 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](http://www.efet.org).



6. The incremental capacities and associated costs from **potential TSO investment projects are published** before the annual long-term capacity allocation process. For each point there should be a series of price steps showing how much additional capacity could be made available at each price step.
7. Long-term capacity allocation enables shippers to place **bids for capacity using price steps**. Shippers will indicate how much capacity they are prepared to buy at each price step. TSOs will aggregate shippers' bids to show how much capacity is demanded at each price step.
8. Where the allocation process clears (e.g. the amount of capacity demanded at a price step equals or is less than the capacity offered at that price step), the TSO will **allocate the capacity requested to the market** so long as it passes the investment test.
9. The process is repeated annually, or perhaps biennially, for a transitional period, and any incremental capacity that satisfies the investment test is immediately **included as an FID project in the TYNDP database**, regional and national plans.

This approach will help there to be consistency across all capacity allocated at existing interconnection points, whether it is existing capacity or incremental capacity. Our recommendations draw on the best principles of TSO and regulatory cooperation, as well as on the lessons learnt from successful and unsuccessful Open Season processes<sup>3</sup>.

### **What is missing to enable this process to take place?**

Improved cooperation is required for most of these steps, but only the investment test in item 5 is a 'new' element that requires EU-wide development. A pilot scheme to develop a successful investment test was explored by the Northwest Gas Regional Initiative (GRI) in 2009-10. This pilot was for a very large pipeline project involving four countries, but a simplified approach could also be applied to cross-border pipeline capacity.

As a rough guide, a simple NPV trigger can be used, provided it is recognised that probably not more than 50-70%<sup>4</sup> of the costs should be covered by long-term commitments by market participants made prior to construction of the project. Other sources of funding could be long-term and short-term commitments post FID (as are already proposed in the EU CAM Network Code), or in special cases a social funding element, for security of supply or other public service reasons.

### **Is there a need for a new EU legislative instrument?**

Whilst several aspects of EU gas legislation will interact with this process, implementation of the above steps could be carried out by regulators, TSOs and market participants without

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<sup>3</sup> The recommendations are also a useful guide for large new projects that would create new interconnections in Europe, but this is not their primary intention. Large project at new locations are likely to require a lengthier, bespoke approach with an initial non-binding phase to test the market, for example, if the infrastructure were exempt from full regulatory TPA.

<sup>4</sup> In Great Britain the investment test uses a 50% of NPV trigger level.



the need for a new EU legislative instrument. It would be helpful, however, if all parties were to agree this approach as part of the target model for the EU gas market. It will also be important to bear in mind the need to facilitate market-based economic investment in, and allocation of, incremental capacity during the development of various EU framework guidelines and EU network codes (for example on CAM and on tariffs). The described approach works best if it is an integral part of the long-term allocation process, i.e. for a given point shippers bid for capacity, whether existing or potential, in the same process. In this way, if demand for capacity is equal to or less than the available capacity, shippers will pay the base regulated price for that capacity. If demand for capacity exceeds the available existing capacity, shippers pay for the additional capacity depending on which price step enables the process to clear.

### **In conclusion**

As EFET stated at the 20<sup>th</sup> Madrid Forum:

*“Currently, there is no mechanism for TSOs to provide additional capacity if demand for capacity exceeds existing availability. This is a major shortcoming. ... The lack of clarity as to how TSOs will meet the unsatisfied demand for capacity creates unnecessary uncertainty for shippers, which in turn will also lead to distorted bidding behaviour.*

*It is therefore essential that the long-term allocation process be combined with a process whereby incremental capacity can also be allocated subject to a suitable lead time. We believe that this is fully compatible with the Framework Guidelines proposed by the Agency ... and urge ENTSOG, CEER, the Commission and ACER to start work with stakeholders to develop such an approach...”*

We therefore urge all interested parties to aim for implementation of these key steps, including the development of an economic test to facilitate market-based decision-making with regulatory oversight of investment in incremental capacity.

**EFET Gas Committee**

**19<sup>th</sup> January, 2012**