

# **Capacity allocation process characteristics**

## **Initial follow up of EFET ‘Capacity Allocation Framework Guideline Essentials’**

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### **Introduction**

Since the release of the ERGEG consultation on the Capacity Allocation Framework Guidelines, ENTSOG has started their preparations for the drafting of the Network Code on this topic. In this process, the EFET capacity group has provided input into the ENTSOG process on a regular basis. EFET’s responses for the CAM and CMP guideline consultations have been used as a basis of these discussions, with a focus on the establishment of a transparent and practical way for ENTSOG to ensure market involvement.

ENTSOG has indicated that it will soon propose a consultation process including formal consultation rounds and more informal working groups. All market parties will be invited to take part in these processes. This proposal by ENTSOG is not likely to be published before the invitation from the European Commission to start drafting the Network Code.

Ahead of this, EFET has been asked to provide a more detailed view on the auction processes for capacity allocation. This paper provides the initial part of such a description, integrating past market experiences and ideal views for the future European gas market. We envisage publishing additional detailed descriptions of topics within scope of the capacity allocation Framework Guideline in the course of the development and implementation of the Network Code, to provide ENTSOG and ERGEG/ACER with a view of the needs of European market parties.

### **Standard products**

Day, Month and Quarter products are sufficiently flexible, if set up in the correct allocation schedule, to facilitate the (commodity) needs of the market. The combination of several of the same products should be facilitated, to form capacity contracts with durations that cover the whole time range of available capacity.

ENTSOGs report on the outcome of their online capacity survey indicated that the ‘gas year’ product was also a favourite. EFET believes that yearly products are not necessary, due to the possibility to combine monthly or quarterly products to form a capacity contract with a duration of a year. This is especially useful since many different yearly products are needed in bordering market or even within a market; gas year, calendar year, storage year. Day, month and quarter products are sufficient, providing they can be combined to match the needs of the market.

## Auction schedule

EFET has used the time schedule as is currently applied to UK auctions as a basis for the European auction schedule, as this has proven to work practically. Quarterly long term, annual monthly, rolling monthly, day ahead and within day allocation rounds are proposed with suitable lead times between allocation and start of the capacity contract.

The EFET capacity group realises that the longer term auctions (Quarterly long term and annual monthly) require significant time for analysis for market parties and are therefore best not scheduled at the same time in all EU countries. Both larger companies, with possibly a more geographical spread in their capacity portfolio and small companies, with less manpower to conduct analysis, would benefit from a regional grouping of these longer term auction processes, instead of having one schedule for the whole of Europe. The EFET capacity group has not yet proposed regional groups. We believe this is best discussed with TSOs and market parties throughout Europe and request ENTSOG to facilitate such a discussion.

Shorter term allocation processes; rolling monthly, daily and within day, take place several times a year (each month, each day or even on the hour) and are linked to short term capacity contract durations. As this requires less analysis and financial commitment, EFET believes that the auction schedule for these products can take place at the same time in all European markets.

The table below represents the proposed time schedule for European capacity auctions:

Type of allocation	Lead time (e.g. time between allocation process and start of allocated capacity)	Contract duration	Capacity product	Share of total calculated capacity
Quarterly long term allocation	1.5 years for existing capacity 3 years for new investments	Any (combination of) quarters from 2.5 up to 15 years <sup>1</sup> out	Quarterly	Maximum 80%
Annual monthly allocation	2 - 6 months	Any (combination of) months up to 18 months out, up to the quarterly long term allocation	Monthly	Total calculated capacity minus allocated long term firm capacity
Rolling monthly allocation	10th of the month prior to the month of use	One month	Monthly	Total calculated capacity minus allocated quarterly long term and annual monthly capacity
Day ahead allocation	Day ahead for Tuesday - Saturday and on Friday for Sunday and Monday	One day	Daily	Total calculated capacity minus allocated quarterly long term and annual monthly capacity

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Within day allocation	During the gas day	Remainder of the day	Daily	Any remaining available capacity
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### Price setting

ERGEG and the European Commission are not including pricing, tariffs and cost regulation in the work on the Capacity allocation Framework Guidelines. However, the allocation process design will only be successful if the right financial incentives are integrated in the model for both market parties and TSOs. This is why EFET proposes high quality pricing principles that are detailed and non-discriminatory and provide tariff transparency for market parties before they commit. It enables market parties to balance their capacity portfolio to match their flow pattern. In addition this proposal enables TSOs to recover their costs of investment, including a regulated rate of return.

The price setting of capacity products should be designed to incentivise TSOs service provision and market parties' booking behaviour that reflects (and improves) the actual supply and demand situation. A **long term volume based auction**<sup>1</sup> should provide a pre-defined price per unit based on the regulated cost of capacity. Depending on the total amount of capacity booked at that point, a new investment can be triggered, if it meets the economic test, and a different (cost and therefore) price level applies<sup>2</sup>. This process integrates Open Seasons into the regular, transparent and efficient process of capacity allocation.

This type of auction allows market parties to indicate their desired capacity over a 15<sup>3</sup> year period for each of the pre-defined price levels. Several auction rounds allow market parties to gain insight in the overall market demand and fine-tune their bookings to the expected final price (and investment) level. The price per unit for several demand scenarios is pre-set by the TSO, allowing them to obtain regulatory approval prior to the auction and ensuring the desired revenue recovery for the booked capacity. This mechanism facilitates an integration of the allocation of existing capacity and open seasons on the capacity supply side, by focussing on market demand discovery for the long term.

The following, **shorter term auctions** should allow the TSO to recover their remaining costs (and associated regulated rate of return). Unlike the long term auctions, which allow for new investments if demand exceeds existing available capacity, these short term auctions have a maximum volume allocated to them (e.g. all remaining primary capacity for that auction period). In case of congestion, this could lead to allocation issues if the auction is combined with a volume based auction mechanism. To prevent this, a **price based auction** mechanism should be introduced for all auctions other than the quarterly long term auctions.

The price based auction should include a reserve price, which can and should be set to incentivise the right balance of bidding behaviour between the different auctions, but without

<sup>1</sup> A volume based auction allocates capacity based on the demand of the market, against a regulated tariff. The TSO publishes the tariff for each 'step' of the auction, whereby the first step contains the total available capacity and next steps indicate several new investments. Each step has a regulated tariff, as approved by the regulator. Market parties only indicate the desired amount of capacity at each price level, making this a volume based auction, rather than a price based auction.

<sup>2</sup> This approach has been discussed at length between TSOs, market participants and regulators as part of the North West Europe Gas Regional Initiative.

<sup>3</sup> 15 years is the period used in the UK long term auctions. The long term auction should allow market parties to book up to the last year in which capacity is made available by the TSO. At the moment, this differs per regulatory regime.

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distorting prices paid for capacity in the shorter term auctions (e.g. disincentivising bidding by setting reserve prices too high or disincentivising long term commitments for new investments by setting reserve prices too low). The latter is a useful way to indicate the supply and demand situation (i.e. very high prices above the long term regulated price for capacity could be one indicator of congestion / shortage of capacity at a particular cross-market point).

EFET envisages the reserve price to be set between zero and the marginal cost level. Setting the reserve price of the capacity at the regulated tariff ensures the TSO can recover its costs, if and as far as these have not been recovered through the long term auction. This mechanism must however be combined with a measure to ensure over-recovery is corrected (i.e. users do not pay more than the regulated cost of capacity in the long run), which should be closely monitored by the regulator. Lowering the reserve price to below the regulated level may, especially in a non-congested situation, lead to a disincentive to book long term contracts and thereby result in an under-recovery of revenues if prices paid in the shorter term auctions are below the long run regulated price. Instead, over-recovery can be corrected by giving rebates to users within the relevant revenue year, lowering the regulated tariffs of the following year or using the over-recovery to fund new investments under NRAs supervision.

EFET realises that currently most countries have different regulatory regimes that may not all allow the price setting proposal to be implemented. However, in the current process of implementation of the third package, it is likely that the national regulation will have to go through extensive changes. This will provide the opportunity to ensure harmonisation in that area. Until this harmonisation takes place, we believe that NRAs and TSOs should implement this price setting structure as far as their current regulation allows, encouraging a transparent, non-discriminatory and (cost) efficient allocation of capacity. The new European Network Code should prescribe the desired regime for the future, unhindered by the current national regulation.

### **Number of rounds for each allocation**

Especially in the long term auctions, EFET believes it is important to include more than one booking round for market parties to indicate their demand. These multiple rounds, combined with the transparent pre-approved tariff indications for each total booking level, allows market parties to ensure a booking at the required capacity amount and price, to match their commodity portfolio. The Network Code should allow there to be multiple rounds in auctions, but provide room for market parties and TSOs to agree the exact details as and when the relevant markets mature.

### **New and existing capacity**

The latest Framework Guideline proposal from ERGEG does not foresee a joint allocation of new and existing capacity. EFET strongly opposes this situation, as this will not lead to a stable, non-discriminatory allocation process. As indicated above, both new and existing capacity should be included in the regular auction process, to allow supply and demand of capacity to find each other in a market based and efficient manner.

A separation of the capacity allocation into a regular auction and an open season process creates several problems that can be avoided through an integration of these two processes. In addition EFET does not see any substantial benefits to a separation of these processes. EFET believes an integrated process utilises the opportunity to bring together, on a regular basis, the

supply and demand at a particular point. This process enables market parties a yearly opportunity to flag additional capacity needs and it will trigger (and secure) new investments when financially viable. It provides market parties with the transparency needed to commit to long term bookings and allows TSOs to assess and address market demand in the most suitable way. TSOs should do this through overselling and buy-back, by using efficient congestion management tools and through small or large investments, or any other ways that optimise the capacity utilisation of their grid.

The quarterly long term auctions provide the market with the opportunity to indicate and secure their long term capacity needs, against pre-defined price steps. This transparency and stability incentivises market parties to bid for their actual needs, as they know they can book additional capacity in the next auction. In addition, this process allows the TSO to signal future demand and secure their investment, through a volume based long term auction, and a price based on the costs of the grid and additional investments, as well as the regulated rate of return.

The above regulated price per unit, which is used in the volume based long term auction, guarantees stability for market parties and return on investment for TSOs. However, if this stable price is used in a congested situation, without the possibility of allowing the demand to lead to new investments, allocation of the capacity cannot be done on a non-discriminatory basis without using pro-rata. As this leads to a high level of uncertainty for market parties, this situation should be avoided, by integrating the allocation of new and existing capacity into one regular auction process.

EFET realises that there may be specific situations that would benefit from a separate open season. Only if one of the pre-defined special cases occurs, such as a completely new cross border pipeline or cross border point, could a separate open season take place. However, this separate process should have exactly the same format as for the long term auctions (i.e. investment trigger and price transparency, volume based auction, etc).

As ERGEG has established and confirmed in their Framework Guideline, for all primary firm available capacity it is important to reserve a percentage of capacity for shorter term bookings. This reservation provides a mixture of capacity contract durations that allow market parties to better adjust their capacity portfolio to their flow patterns. Additionally, in case of congestion, it ensures capacity remains available after the initial long term auction, allowing new entrants entering a market after that time (as well as all other parties) access to capacity.

For the above reasons, EFET believes that TSOs should apply a 20% reservation to all available firm primary capacity for short-term auctions. This reservation should include capacity resulting from new investments.

### **Daily capacity**

In principle all daily capacity products are allocated on a day-ahead basis. However, for practical purposes, Sunday and Monday (and holiday days in one or both of the markets of the cross-market point) shall be allocated at the day ahead auction of the last working day prior to the day of use. This implies that on Friday capacity for Saturday, Sunday and Monday will be up for auction.

### **Definition short and long term capacity**

EU Regulation 715/2009 defines long term services as services of one year or longer. Short term services are classified as being shorter than a year. If services are seen to be capacity products, this would classify all day, month and quarter products as short term – in essence, every capacity product offered by National Grid would qualify as short term product. If however the capacity contract duration is indicative for the definition, some quarterly long term bookings and some annual monthly bookings are long term, but all other bookings, including some quarterly and monthly ones, are classed as short term.

EFET believes that a clarification of these definitions for use in the Framework Guidelines and Network Code would be useful. However, the definitions should not stand in the way of the implementation of the auction process as described in this paper. For the purpose of this paper, EFET defines the quarterly long term auction process as a long term service, even when some of the resulting bookings have a duration of less than a year, as it enables shippers to book capacity over several years, respectively to book single quarterly products with a lead time of several years. All other auction processes are viewed as short term, even though the annual monthly auction can provide a capacity contract duration of more than a year.