

Consultation on ERGEG principles: Capacity allocation and congestion management in natural gas transmission networks

Statement of RWE

Introduction and General Comments

RWE welcomes the opportunity to respond to this consultation, and is happy to be contacted about any comments below.

We highly appreciate ERGEGs efforts to address the topics capacity allocation mechanisms (CAM) and congestion management procedures (CMP). RWE is convinced that both areas are key requirements to make effective competition in the supply, trading and retailing of gas possible. CAM and CMP rules have to ensure that transmission networks are built, operated and used to their maximum capacity thereby maximising the scope for the market to work in delivering more efficient gas supplies while maintaining secure and reliable transmission.

We understand that the main purpose of this consultation is to prepare for the Agency the Framework Guidelines for the Network Codes as envisaged by the Third Energy Package. We strongly support ERGEGs efforts to start preparations early in order to facilitate the process. RWE considers the Framework Guidelines and the Network Codes as key elements to abolish existing trading barriers. Currently, inconsistencies in the member states' energy laws may hinder cross-border cooperation. Therefore, we argue to use Framework Guidelines and Network Codes as a harmonisation tool:

- All material characteristics of the capacity allocation/congestion management system shall be stipulated in the Framework Guidelines / Network Codes in order to guarantee at least the compatibility of the conditions of the interconnector access.
- The national regulatory authorities shall not design individual models for the elements. Otherwise, the existing fragmentation will persist in the EC.
- Framework Guidelines / Network Codes shall require TSOs to implement the new allocation and congestion management rules without undue delay.

In the following, we do not differentiate between Framework Guidelines and Network Codes. We are convinced that all institutions will cooperate goal-orientated when drafting the Guidelines and Codes and are going to take the results of this ERGEG Consultation very seriously. Having said that, RWE thinks it is important that the Framework Guidelines themselves address all key issues in order to facilitate the process of drafting the Networks Codes.

With regard to content, we think the following principles are suited best to improve capacity utilisation in order to advance cross-border trade:

- TSO shall provide full technical capacity.
- TSOs shall provide financially firm capacity as a standard product.
- In the future, interruptible capacity should rather be an exception than standard. It may still be offered e.g. to customers who have no need for firm capacity – typical example is the filling of storages.
- TSOs shall auction capacity at a market clearing price and TSOs should have the chance to actively participate in the secondary capacity market (eg, as an option in managing outages or unforeseen capacity reductions).
- Regulators should provide TSOs with appropriate incentives – and secure the removal of regulatory constraints – to allow TSOs to maximise the sale of financial firm capacity and to compensate them appropriately for any commercial risks taken in the provision of a commercial, economically optimal transportation service.
- Any surplus capacity revenues – over and above regulated tariff rates – should be separately accounted for by the TSO and, in order of priority, should be used to guarantee the firmness of existing capacity and to manage the associated risks, to make efficient investments in reinforcing and expanding capacity and to reduce final domestic transportation tariffs.
- The “Use It or Sell It” principle shall be applied to avoid capacity hoarding. Capacity which is not nominated (minus a certain renomination reserve, if applicable) shall be auctioned by the TSO on a day-ahead basis. The un-nominated capacity owner shall receive the proceeds of the auctioning, however not more than the price payable according to regulated tariffs. All capacities have to be nominated.
- National Regulators shall cooperate intensively to ensure efficient cross-border trade and efficient and at least compatible network access.
- CAM and CMP should not unduly affect negatively valid existing capacity contracts. The ability to conclude legally certain long-term capacity contracts is crucial to underwriting future investments in gas supply and ultimately security.

1. Do you agree with the problems that ERGEG has identified with capacity allocation and congestion management? Are there other aspects that should be taken into account?

We share the key elements of ERGEG’s analysis of the current situation: We agree that regulatory obstacles to cross-border gas flows remain a major barrier to market integration at an European level. The current system does not ensure in all relevant cases that all technical available capacity is utilized according to the market demand.

Even though CAM and CMP cannot be a substitute for the necessary system enhancement, it can be an important step to improve the situation by increasing capacity utilisation.

2. The scope of ERGEG's principles and of the derived proposals covers bringing capacity to the market where there is currently contractual congestion. Do you agree with this approach?

We agree that improving capacity utilisation is an important instrument to address the problem of contractual congestion in gas transportation. However, it has to be complemented by swift and consistent efforts to increase the physical capacity by network extension. The European CAM/CMP initiative may not be used as an excuse to delay the necessary physical network extension where there are substantial deficits in the interconnector capacity. CAM and CMP are no panacea.

3. In principle, European regulators consider FCFS allocation potentially discriminatory. Do you share this view? What do you think about the proposed mechanisms (OSP) with subsequent pro-rata allocation or auctioning)?

RWE agrees that FCFS allocation has not proven to be an appropriate, market based approach to address congestion.

Therefore, for **congested interconnectors**, at least, we propose an **auctioning** of capacity rights with a market clearing price. The lowest successful bid shall set the price for all shippers in order to provide for equal treatment. Auctioning assures that the capacity is allocated in a transparent, non-discriminatory, and economically efficient way, providing that the capacity rights are used to create the highest economic benefit. In addition, auctioning gives network operators a clear economic signal for the efficiency of network extension measures. Long-term high prices (in comparison to the regulated tariffs) suggest that there is a demand for additional capacity.

We do not consider the OSP approach useful. It means that shippers have to wait for the relevant booking period to come before they are able to book capacity. This delay is unnecessary where there is no congestion. For entry/exit points where the regulator has found no congestion according to G.1.1 there is no need to force all system users in a uniform open subscription period. Flexible bookings of capacity rights for a period of ten years in the future should be possible. A pro-rata allocation is problematic. It means that traders requesting the highest amount of capacity will succeed. Random results are the consequence.

4. In your view, what is the future importance of the proposed capacity products (firm, interruptible, and bundled) and of the proposed contract duration (intra-day up to multi-annual)?

TSOs shall offer (**financially**) **firm capacity** as the standard product.

Interruptible capacity should be used as an optimisation tool in limited

circumstances. The provision and sale of interruptible capacity should be the exception rather than the rule. Allowing system operators to sell capacity as interruptible to a larger extent inevitably undermines the ability to completely hedge the full volume of expected gas flows.

For TSOs incentives have to be set to operate, maintain and construct an efficient system. System operators should therefore sell a maximum of the capacity as forward firm capacity. At the margins around the firm capacity, however, it may occasionally be useful to offer an interruptible product, e.g., if capacity becomes unexpectedly available.

Risks should ultimately lie with the party best placed to manage that risk. If TSOs are considered to be best placed to manage the corresponding risks, regulators have to guarantee that the regulatory framework will provide TSOs with full financial compensation and appropriate incentives to maximise the provision of financially firm capacity.

Historically, the “firmness” of capacity has been considered a largely physical concept, effectively translating into a guarantee that physical capacity will be available at all times. This approach has led to the underprovision of capacity as system operators seek to avoid the risk of having to interrupt firm capacity by reducing the volumes sold.

However, efficient hedging does not require such a “physical” guarantee providing that financial compensation is paid to “make good” any failure to provide transmission. **Compensation payments** should be based on the opportunity cost of the failure to deliver, e.g., the difference between the spot prices of the export and import markets in the case of cross-border capacity. That also explains why liquid commodity market places in both markets are necessary prerequisites for offering firm capacity products. Full financial compensation for this risks has to be guaranteed by adopting regulatory framework and has to be accepted by NRA.

TSOs shall adopt all commercial measures making additional contractual capacity available as long as the costs are below the expenditures for a physical upgrading. The available commercial means should be matched against the costs of a physical network extension. For example, **flow commitments** are an efficient tool to improve capacity utilisation. If available in the market TSOs should use flow commitments to offer firm **backhaul** capacity according to demand if technically possible and economically reasonable. In cases where system operators can foresee that capacity will be lower than expected they can also offer capacity from market participants at prevailing market rates in the secondary market (it has to be considered, how market participants can be forced or incentivized to give back the spare capacity – “use-it-or-sell-it” or “use-it-or-get paid” principles). Costs shall be borne by the system users. TSOs shall not be prevented from selling interruptible **“stand by” capacity** *in addition to the full projected capacity* for users which have no need for firm capacity (e.g. to fill a gas storage facility over time) at a discounted tariff. However, the Framework Guideline/Network Guidelines shall still provide that TSOs are nevertheless adequately incentivized to maximise the forward offers of financially firm capacity.

We think that **bundled products** are a key element for a new capacity allocation system. Therefore, cross-border capacity should be offered for all interconnectors as combined entry-exit rights to the neighbouring countries or regional hubs. Framework Guidelines/Network Codes shall oblige national regulatory authorities in all countries to implement bundled products within a certain timeframe.

At the same time, TSOs shall continue to offer **separate entry/exit** rights for the interconnection points. This is e.g. necessary if the network points are not used for cross border shipping. The performance of certain commodity contracts requires that separate entry/exit rights are available.

In any case, TSOs and regulators have to ensure that capacity allocation match. Marketing of **intraday day capacity** is important to improve capacity utilisation and prevent capacity hoarding. There Framework Guidelines/Network Codes shall bindingly require that whatever capacity is available should be offered to the market as short-term capacity. We can see no economic justification for keeping unused capacity away from the market.

We consider **consultations** with market participants crucial when deciding about the (term of) capacity products offered. The demand of system users should decide what capacity products are offered. Based on the consultations, system operators should aim to provide sufficient liquidity to the forward transmission markets to facilitate efficient hedging of transmission risks and to facilitate effective competition within and between market hubs. The operators of adjacent system should jointly consult the market participants on their capacity demand on an interconnector. A range of standard term products shall always be offered.

No uniform predefined range for **short term** capacity (G.2.2) shall apply for all network points as market needs do differ considerably. At network points where gas is imported based on long term contracts only, there is typically no demand for short term capacity products. Only newly-available capacity shall be used to introduce new short term capacity. Existing long term capacity contracts must not be constrained.

In striking an appropriate balance between long-term and short-term sales, regulators should aim to provide **sufficient liquidity** to the forward transmission markets to facilitate efficient hedging of transmission risks and to facilitate effective competition within and between market hubs. Although this will require a degree of judgement by regulators in consultation with market participants, they should weight sales in favour of long-term sales to avoid unduly constraining the secondary market in rights; it is considerably easier to break down long-term capacity into smaller, short-term chunks than it is to synthesise long-term capacity from the expected future release of uncertain volumes of short-term capacity.

We do not agree that the offer and use of separate capacity for transit purposes shall be avoided. We are of the opinion that **transit capacity** is indispensable for transmission systems with a high transit use. These transmission systems are specially designed for the transit use. It was not build to give transit gas access to all national exit points. Therefore, TSOs typically will have to significantly reduce the contractual available transit capacity in order to allow unlimited access to any exit point - even if transit users usually have no demand for access to non-transit exit points.

However, we point out that maximizing capacities and firmness of capacities can only become reality if regulators implement well balanced approach of changes and risks for TSOs. Disincentivising TSOs, like missing cost recovery mechanism, will not lead to the mechanism which are needed for the development of liquid energy markets. We therefore fully share the ERGEG-Paper “Firmness of nominated capacities” (E08-EFG-29-05, 15.07.2008), in particular paragraphs 59, 60 and 63.

5. What is the role of secondary capacity trading?

An active secondary market in the capacity rights is essential to realign capacity rights between users over time and to ensure the optimal use of the transmission network. System operators must facilitate this process by ensuring that contractual rights to capacity can be transferred freely between market participants in the secondary market. The Framework Guidelines/Network Codes should ensure that capacity rights are freely tradable in a secondary market. An active secondary market in the capacity rights is therefore essential to realign capacity rights between users over time and to ensure the optimal use of the transmission network. System operators must facilitate this process by ensuring that contractual rights to capacity can be transferred freely between market participants in the secondary market.

National regulatory authorities should not be entitled to decide that secondary capacity shall not be allocated before primary capacity is fully subscribed. Capacity holders must be entitled to transfer their position at will if they cannot or do not want to use their capacity rights. We can see no justification for a restriction of the capacity holder’s freedom of contract.

The transfer of the right to use the capacity shall not require a transfer of the payment obligations from the original purchaser. Although contracts could potentially be novated with the consent of the system operator (as the seller of the capacity), the rights to use capacity can – and should – be capable of being transferred independently of the relevant payment and credit arrangements.

6. How do you assess the proposed measures to enhance the availability of firm capacity and to improve short-term and long-term congestion management?

We appreciate the proposed measures in general. However, we consider the approach of **financially firm** capacity essential to improve the European gas market. Financially firm transmission capacity is needed to enable market participants to hedge their portfolio of gas purchases and sales efficiently. It is no use being able to lock in a fixed prices for gas purchases and sales, if you subsequently have an open ended risk that you won’t be able to deliver the gas that you have bought.

RWE agrees that **renomination** shall be limited in order to improve liquidity on the day-ahead secondary market. A renomination margin of 15 percent based on the [nominated] capacity is needed to account for the risk of suboptimal forecasts and to provide balancing gas or flow commitments to the network operator on a within day basis. In the long run, it should be considered to replace renomination possibility by

liquid intraday markets. Therefore, a phase down of renomination rights as market's liquidity improves could be appropriate. Regulators should consult the market participants beforehand.

The **same rules** shall apply for all users irrespective of their market share. All systematically unused capacity shall be withdrawn and made available to other market participants. There is no reason to allow traders with a small market share wider renominations rights. The 2+2 rule seems to come to random results and is discriminatory. Small shippers are disproportionately better off than large shippers.

In general, any **costs** associated with the offering of financially firm capacity should be borne by system users as beneficiaries of liquid markets. Although it is also worth noting that financially firm capacity might generate higher revenues. Part of the costs and revenues may be allocated to the TSO in order to give incentive for an improved capacity utilisation. TSOs have to be compensated for the additional risk.

RWE advocates the "**Use It Or Sell It**" principle. We agree that anti-hoarding provisions are necessary to ensure the efficient usage of capacity and to protect against capacity holdings being used to limit competition in the underlying product market. These provisions need to be balanced against the rights of parties to receive the benefits of the rights that they have purchased. This should be addressed by imposing a deadline for usage nominations coupled with a procedure for reselling any unused (or unexpectedly available) capacity back to the market on a day-ahead market ("**Use it or sell it**"). The application of an UIOLI principle, however, where capacity holders do not gain the value of their capacity rights, is disproportionate.

Therefore, not nominated capacities shall be auctioned by the TSO on a day-ahead basis. The not nominating capacity owner shall receive the proceeds of the auctioning, limited to the price paid by him according to regulated tariffs.

7. What are your views on the proposals? Do they address the problems? Will they lead to more effective capacity allocation methods being developed?

RWE considers the tools proposed by ERGEG a step in the right direction to improve capacity utilisation. The proposed measures are cross-linked, and can not be implemented isolated: e.g. a reduction in renomination requires liquid secondary capacity markets. However, we suggest more forceful measures:

- Framework Guidelines / Network Codes shall to the extent technical possible and reasonable provide for an at least compatible CAM / CMP framework for all member states.
- Financially firm capacity shall be offered as a standard product.
- The "Use It Or Sell It" principle shall be applied to avoid capacity hoarding.
- The Framework Guidelines / Network codes shall ensure that system operators are appropriately incentivised and remunerated.

- National Regulators shall cooperate intensively to ensure efficient cross-border trade and efficient network access.
- CAM and CMP may not affect negatively existing and valid capacity contracts unduly. The ability to conclude legally certain long-term capacity contracts is crucial to guarantee security of supply.

8. Are the needs of shippers performing supply activities properly taken into account?

Existing capacity rights must be respected in the transition to new capacity markets. The introduction of efficient markets in gas transmission capacity rights must not abrogate or undermine existing contractual rights to use the network. Shippers rely on existing capacity contracts in order to execute their long-term (take-or-pay) gas supply contracts.

Undermining the contractual rights for past investment in transmission capacity provides a worrying and costly precedent for prospective decisions to finance and construct transmission and to acquire the corresponding rights.

In the event that historic rules and procedures are inconsistent with the desired future model, regulators should ensure an appropriate and acceptable path for reflecting the economic rights enjoyed under the historic contracts in the new arrangements.

The need to respect existing rights in order to provide regulatory stability would also clearly not override any changes to existing contractual rights resulting from agreements struck with competition or energy regulators in the course of their investigations and actions.

9. Are the proposed measures suitable to facilitate development of liquid gas markets?

We highly appreciate ERGEGs efforts to address the topics capacity allocation mechanisms (CAM) and congestion management procedures (CMP). RWE is convinced that both areas are a key requirement to support possible effective competition in the supply, trading and retailing of gas. CAM and CMP rules have to ensure that transmission networks are built, operated and used to their maximum capacity thereby maximising the scope for the market to work in delivering more efficient gas supplies. [see answer to question 7]

10. In your view, how important are compatible booking and operational procedures between adjacent systems?

Uniform booking and operational procedures are important. We argue for a full harmonisation of the conditions of the interconnector access. The national regulatory authorities shall not design individual models for the elements. Otherwise, the existing fragmentation will persist in the EC.

We appreciate that transportation contracts and network codes shall be aligned. However, we think it not practical to require TSOs and national regulatory authorities

to stipulate individual transportation contract and network codes for every border. The transaction costs of TSOs, network users and regulators for dealing with a multiplicity of access regimes are high:

- For example, a TSO which borders five countries has to negotiate with five TSOs and has to deal with six regulatory authorities. It has to use five different templates of transportation contracts and apply five or more different network codes. There is risk that different regimes are considered discriminatory.
- At the same time, system users might face the burden of different contracts and network codes at every interconnection point.
- Regulators have to negotiate individual solutions with all neighbouring countries.

We favour a system where the Framework Guidelines/Network Codes provide for uniform rules for contract provisions and network codes for all interconnectors. Rules shall be as specific as feasible. A far reaching harmonisation will minimise the administrative efforts for TSOs, system users and the national regulatory authorities.

National regulatory authorities may allow exemptions from these specifications for certain interconnectors if the standard rules do not fit due to technical particularities of the interconnector or the given network configurations. Every exception needs a substantiated (technical) justification. Framework Guideline/Network Codes should describe the circumstances where exceptions are possible.

National regulatory authorities should aim for a reduction of these exemptions and require TSOs to implement the necessary measures.

11. Do the proposed measures increase the efficient use of the system? What aspects would you support and like to see further developed?

We consider to additional aspects important:

The methods of **capacity calculation** shall be analysed on a European level to in order to maximise the contractually available technical capacity. Capacity calculations should also be flexible and dynamic. System operators should continually appraise and calculate the actual capacity on their network.

Incentives should be mandatory to ensure that inertia in calculating, allocating and selling capacity and to ensure the dynamic management of the network and to maximise the system operator's ability to move gas between markets. For example, a bonus can be granted the amount of offered firm capacity is increased compared to historic values. This system has to duly take account for the structural differences and divergent capabilities of the individual grids.

Regulators should recognise that there is no single correct "capacity" figure, but a spectrum of capacities associated with an increased commercial risk of interruption and hence the need to arrange alternative deliveries and/or pay liquidated damages. In this context, even minor shifts in the balance between risks and rewards can yield significant improvements in the amount of capacity made available as the trade off

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between the increased likelihood of having to buy back capacity, rebalance the network or to pay liquidated damages making is weighted against the additional capacity sales revenues.

(It needs to be stressed that this is solely a “commercial” issue. Increased allocations do not in themselves increase the underlying risk of network insecurity since the network’s physical capabilities have to be respected at all times, irrespective of the amount of capacity sold).

It is essential that regulators incentivise system operators to provide a commercial transmission service by offering additional returns for exceeding relevant performance targets (e.g., building new capacity, selling capacity forward, increasing network utilisation, reducing congestion etc). The incentives have to be transparent, non-discriminatory and predictable. The targets shall be defined in way that assures that they can be met and outperformed by the TSO.

It is efficient to allow additional profits for TSOs if they account for additional (firm) capacity rights because system users benefit from improved capacity utilisation: on the one hand lower tariffs due to the improved capacity utilisation of the system, on the other hand a better satisfaction of their capacity demand. The value of these gains will exceed the additional costs of the incentivisation.